PRINCIPLES OF MARKETING

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MARKETING

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PART 1

THE MARKETING SYSTEM

1. INTRODUCTION

THE NATURE AND SIGNIFICANCE OF MARKETING

The American economy is a market-oriented economy. Industry today involves the production of goods for profitable sale rather than for home consumption by the producer and his immediate household. As our economic system has developed, production has become more highly specialized; and producers and consumers, as well as the centers of production and consumption, have become more definitely separated. Because of these developments the marketing system has become more and more complex, with the result that marketing permeates all phases of business activity and has replaced production as the prime problem of the economy of the United States.

The need for marketing thus grows out of the division of labor. Specialized and large-scale production enterprises require mass markets in which to distribute their products. To reach these markets it is necessary to employ a great variety of specialized marketing enterprises—retailers, wholesalers, transportation agencies, warehousemen, and the like. These markets exist in turn because of the diversity of human wants—a diversity which extends not only to the basic necessities of life but also to the even greater number of acquired wants resulting from the apparently limitless possibilities that human beings have for expanding their desires.

The significance of marketing in our economy has been well expressed by the statement of a former executive of the United States Steel Corporation, "I would rather own a market than a mill." [1] The implication of this statement is that it is relatively easy to acquire and to maintain ownership of a mill, involving as it does essentially the acquisition of physical property.

But the "ownership" of a market is another matter. In fact, a market is served rather than owned. To serve a market adequately the marketing executive must know the characteristics of the people who make up that market, their needs and desires, their purchasing power, their habits and thoughts. He must be alert to the actions of competitors, the products they sell, and the prices they charge. Markets are ever changing: customers come and go, incomes rise and fall, needs and desires change. Constant study and planning are necessary to serve a market and to acquire any significant degree of consumer loyalty and patronage. And even this is always subject to the inroads of competitors with new products and new methods of doing business.

A market-oriented economy then, by its very nature, is a dynamic economy characterized by the steady growth and expansion of markets.[2] In such an economy, it is the function of the marketing system to transform the benefits of production efficiency into higher levels of living for all the people. The low levels of living found in many economic societies may result as much from inefficient marketing as they do from inadequate manufacturing technology. Peter Drucker points out that, in every underdeveloped country, marketing is the least developed part of the economy.[3] As a result these countries are unable to make effective use of what little they have. Mr. Drucker goes on to state that the development of a marketing system in these countries "might by itself go far toward changing the economic tone of the existing system—without any change in methods of production, distribution of population, or of income."[4] Although we usually consider a well-developed marketing system to be a result of the development of large-scale manufacturing enterprise, Mr. Drucker is suggesting, at the very least, that marketing should be developed as rapidly as is manufacturing in order that the progress of the latter not be impeded. His contention certainly points up the importance of marketing in the modern world.

Marketing Defined

Marketing consists of those efforts which effect transfers in the ownership of goods and services and which provide for their physical distribution. The marketing process, consequently, involves both mental and physical aspects: mental, in that sellers must know what buyers want, and buyers must know

what is for sale; and physical, in that goods must be moved to the places at which they are wanted by the time they are wanted.[5]

Marketing is a part of production, as the latter term is used in economics. Production is concerned with the creation of utility, specifically form utility, time utility, place utility, and possession utility. Marketing is not concerned ordinarily with form utility. Changes in the form of a commodity designed to modify its characteristics or uses, such as the transfer of wheat into flour and flour into bread, lie within the province of manufacturing.[6] Marketing is concerned with the creation of time, place, and possession utilities, all of which are implied in the definition of marketing given in the first sentence of the preceding paragraph. Time and place utilities are created during the process of physical distribution. Commodities must be transported from the place in which they originate to the place of consumption, and they must be held in storage until such time as the consumer requires them. Possession utility is involved when transfers in ownership take place.

Although marketing is concerned mainly with the creation of time, place, and possession utilities, it should be understood that the creation of these types of utility does not always involve marketing.[7] A person may transport or store his own household goods and place or time utility may be created thereby. Marketing, however, is not involved in this case because no change in ownership took place or was even contemplated. Thus it is rather difficult to formulate a definition of marketing that will include everything that is customarily regarded as marketing and exclude everything that is not customarily so regarded, but it will help a great deal to hold in mind that marketing is concerned primarily with *changes in ownership* and with the activities necessary to effect these changes.

[5] The Committee on Definitions of the American Marketing Association has defined marketing as "the performance of business activities that direct the flow of goods and services from producer to consumer or user." See *Marketing Definitions* (Chicago: American Marketing Association, 1960), p. 15. Through its study and definition of marketing terms, the Committee on Definitions has performed an important service to students of marketing. Ralph S. Alexander has served as chairman of the committee. The report cited here contains carefully worked out definitions for the most commonly used marketing terms.

[6] Marketing, of course, has a great deal of interest in the characteristics of the final product, and marketing considerations are influential in determining them. See the subsequent discussion in this chapter on marketing functions. It may also be noted that changes in form designed primarily to make the product more salable, such as packaging, are included in marketing. See *Marketing Definitions, op.cit.*, p. 15. For a somewhat different view regarding the relationship of marketing to form, time, place, and possession utility, see Wroe Alderson, *Marketing Behavior and Executive Action* (Homewood, Ill.: Irwin, 1957), pp. 68–9.

[7] For a stimulating discussion of this problem, see Roland S. Vaile, "Some Concepts of Markets and Marketing Strategy," in Robert V. Mitchell (ed.), *Changing Structure and Strategy in Marketing* (Urbana: Bureau of Economic and Business Research. University of Illinois, 1958), pp. 17–8.

The Importance of Marketing

The significance of marketing effort in a modern economy was discussed in a general way in the opening paragraphs of this chapter. The importance of marketing can be demonstrated more specifically, however. For example, the expenditure for marketing activities is a very significant item in our total economic picture. Detailed information regarding the cost of marketing will be presented in a later chapter. For the present, it is sufficient to note that in the United States approximately 50 per cent of each dollar spent for goods represents marketing cost and that the total expenditure for marketing probably exceeds $150 billion per year. Thus the cost of getting goods from the producer to the consumer is about equal to the original cost of producing them.[8]

That marketing is an important segment of our economy is further shown by the number of firms and persons engaged in it. In 1959 there were 4,583,000 business firms in existence in the United States. Of this number, 1,977,000 were classified as retailers and 312,000 as wholesalers, a total of 2,289,000 or almost half of all business enterprises.[9] In addition, there are numerous firms engaged in transportation, communication, financing, and service industries that must also be included in any listing of business enterprises engaged in marketing.

In that same year, the retailers and wholesalers specified above employed over 11,000,000 persons.[10] Proprietors of these firms numbered almost 2,000,-000, giving a total of 13,000,000 persons engaged in retail and wholesale trade alone. To this figure, we must add all those persons who are employed by manufacturing concerns in a marketing capacity; a substantial proportion of the persons engaged in transportation, warehousing, communications, and financing; a large number of persons working in the service industries; and various other persons engaged in business activities auxiliary to the performance of the marketing functions.

It is probable that some 20,000,000 people may be classified as gainfully employed in one form of marketing activity or another. Even this conservative figure represents at any given time from 25 to 30 per cent of the total

[8] Although "production" has been previously defined in the broad sense to encompass all economic activity including marketing, the terms "producer" and "production" will be used in this book in the more commonly accepted narrow sense. Thus "producer" is used here and subsequently as a comprehensive term to designate growers, extractors, processors, and manufacturers—those engaged primarily in creating form utility.

[9] *Statistical Abstract of the United States, 1960* (Washington, D.C.: U.S. Government Printing Office, 1960), p. 484.

[10] *Ibid.*, p. 211.

civilian labor force. Moreover, the proportion of our total labor force that is gainfully employed in marketing has constantly increased in the past [11] and probably will continue to do so in the future. Thus it is not difficult to see that marketing is an important activity in our economy.

SOME BASIC MARKETING CONCEPTS

The Marketing Processes

The ultimate objective of all marketing effort is to place goods in the hands of consumers. Many marketing activities must be performed to accomplish this objective, the major activities being designated as the "functions of marketing." These functions—such as selling, buying, transportation, storage, and others—will be outlined later in this chapter and discussed in greater detail in subsequent chapters. At this point, however, it will prove helpful to understand that these functions are performed within a marketing framework which has been built around a twofold flow of products involving three major processes: concentration, equalization, and dispersion.

Concentration and Dispersion. The first aspect of this flow of products is the process of concentration. Goods which are produced in small lots must be collected into larger quantities at central points in order that they may be marketed efficiently. Concentration is particularly important in the marketing of commodities sold in their natural state. This is true whether they are raw materials of manufacture, such as unprocessed cotton or wool, grain, and iron ore, or commodities consumed in their original form, such as fresh fruits and vegetables. Concentration is also important in the marketing of some manufactured products, especially those which are assembled into other products by large manufacturers. For example, certain automotive parts and subassemblies are concentrated from several suppliers by the large automobile manufacturers.

The second aspect of this twofold flow of products is the process of dispersing toward the consumer or user those commodities which have been concentrated at central points. The large lots that have been collected for efficient marketing must be broken down into the smaller quantities required to meet the needs of buyers. Raw materials are dispersed to manufacturers

[11] Between 1870 and 1950 the proportion of the labor force engaged in wholesaling and retailing increased from 6.1 per cent to 16.4. The numbers engaged in commodity distribution per thousand employed in commodity production increased at a rate of 2.1 per cent per year during this same period. See Harold Barger, *Distribution's Place in the American Economy since 1869* (Princeton: Princeton University Press, 1955), pp. 3–8.

and processors, and products ready for final consumption are dispersed to middlemen for further dispersion to final consumers.

The methods by which concentration and dispersion take place are by no means uniform for all commodities. Some agricultural products, for example, are shipped directly from producers to central markets, from which they are then dispersed, with or without further processing, toward the ultimate consumer. Others are first collected at local markets and are then sent to the central markets. Large retailers often buy directly from producers, and sometimes growers sell directly to consumers. Concentration is not of major importance in marketing most manufactured products, since they tend to be produced in large quantities, but dispersion assumes great significance. Manufactured goods may be shipped from the factory to consumers, retailers, or wholesalers; or they may be dispersed to factory-owned warehouses or to public warehouses, from which they are in turn dispersed to manufacturers, wholesalers, retailers, or consumers. The great majority of products are first concentrated as raw materials, processed, and then dispersed as manufactured products.

Equalization. Between these processes of concentration and dispersion occurs the activity which we call "equalization." Equalization consists of adjustments of supply to demand on the basis of time, quantity, and quality. It is the process by means of which the supply of goods ready for sale is adjusted to the demand for them. Most goods from mines, factories, and farms are produced for the market rather than to fill specific orders; and since production and consumption are often seasonal and demand is subject to frequent fluctuations, the flow of products to the market by no means corresponds in point of time to the demands for consumption. Moreover, in many cases, neither the quantity nor the quality of goods as they come from individual producers meets the needs of those who wish to use them. Individual farmers, for example, do not produce enough grain to supply a single flour mill; and, on the other hand, flour may be shipped from the mill in carloads, whereas most retailers purchase smaller amounts. The vegetable grower may market in truckloads or carloads, whereas the ultimate consumer may wish to buy in lots of a bushel or even a few pounds. The quality of products as they come from individual producers, likewise, may or may not meet the needs of particular purchasers, and so supplies must be adjusted to meet the demands for particular qualities.

Marketing Processes Illustrated. Figure 1-1 outlines the three processes as they are carried on in the marketing of wheat and flour, although it is, of course, impossible to indicate the relative number of producers, consumers, and other parties involved. And it is also impossible to show the constantly

changing conditions of supply and demand in terms of time, quantity, and quality which make the work of equalization so difficult and so important.

The process of equalizing supply and demand is a particular function of the wholesale markets, but it is often carried on by manufacturers and retailers as well as by wholesalers. For some commodities, manufacturers and retailers perform much of the work of equalization and well-organized whole-

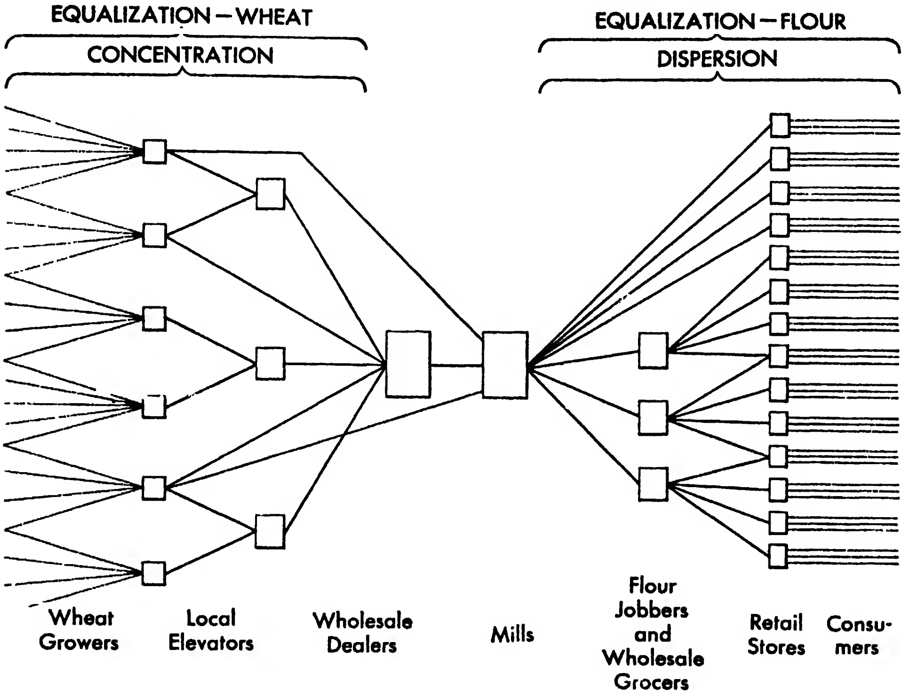

Figure 1-1. Concentration and Equalization of Wheat. Equalization and Dispersion of Flour.

sale markets do not develop. Where such markets do exist, however, they may be looked upon as great reservoirs into which goods flow in varying quantities and in many varieties and qualities. Here they are held until the demand for them brings about their dispersion toward the consuming markets. This is the great service of wholesaling—to acquire goods of the qualities demanded; to accumulate those demanded seasonally; to store products produced seasonally until they are needed; to adjust the flow of commodities toward the points of demand for them; and to take up the slack between the currently changing volumes of production and demand. In addition, this centralization of marketing processes greatly facilitates the transfer of title as goods move from producer to consumer.

Concentration, equalization, and dispersion are the heart of marketing. It is the need for the performance of these operations that makes marketing necessary.

A Market

At every point at which a specific commodity is concentrated for sale a market is found. This is true whether it is being concentrated for further concentration, for dispersion, or, as often happens, for both purposes. Indeed, a market always exists unless the operation is controlled by a single businessman. In that case no change of ownership is involved.

A market, therefore, may be defined as a center about which, or an area in which, the forces leading to exchanges of title to a particular product operate, and toward which and from which the actual goods tend to travel. It leads to clarity of thought to bear these two aspects of market structure constantly in mind: the transfer of the title to goods from seller to buyer, and the physical transfer of the goods themselves. But the physical presence of the goods is not essential, for the distinguishing characteristic of a market is the fact that transfers of title take place therein.

The term "market," as just defined, involves a place or area in which buyers and sellers function. We also use "market" in two other senses: (1) the sphere within which price-making forces tend to operate, as when we speak of a strong market for wheat, and (2) as the aggregate demand of the potential buyers of a commodity or service.[12] In this latter sense, we speak of the market for automobiles, of the retail market, of the teenage market, of the New England market. In each case, an aggregate demand is involved, either for a given product by all buyers or for all products by a given segment of buyers. It is well in using the term "market" to show clearly the sense in which it is employed.

Channels of Distribution

The term "distribution" is used ordinarily as a synonym for "marketing" and is most commonly found in the phrase "channel of distribution." The methods by which transfers of goods and titles are carried on vary greatly. It is difficult and usually impossible for producers and consumers to make direct contact in the exchange of goods. Because of this, middlemen have developed as intermediaries between consumers and producers, and large-

[12] See *Marketing Definitions, op.cit.*, p. 15.

scale producers and buyers have developed highly specialized agencies under their own control to perform marketing operations. Consequently, many combinations of agencies are used for performing the operations involved in the transfer of titles. The combinations that are used depend on the nature of the product, the conditions of its supply and demand, and the development of market techniques, considerations to be discussed in later chapters.

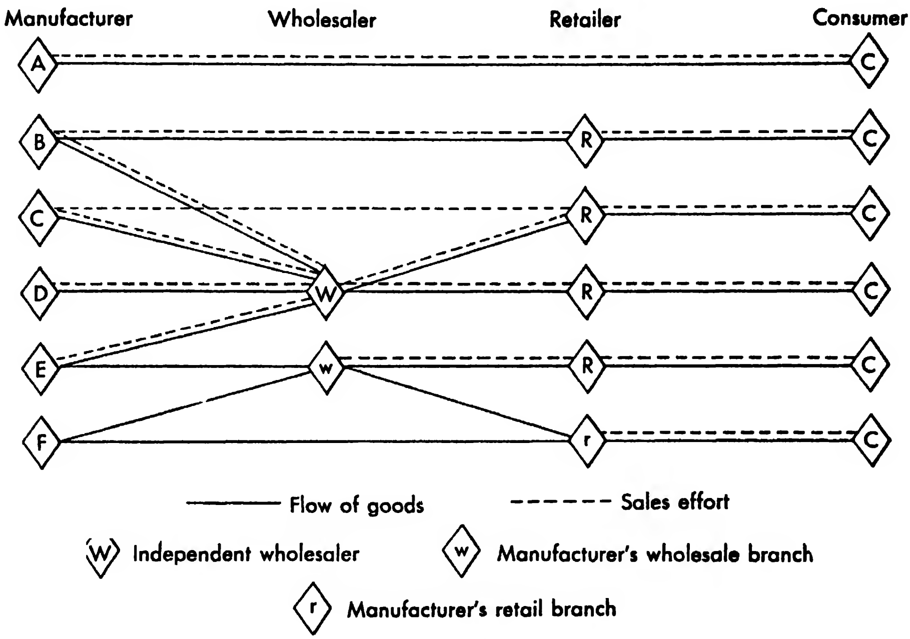

Figure 1-2. Channels of Distribution for Manufactured Goods.

A channel of distribution is the course taken in the transfer of the title to a product. Title to some goods is passed several times while they are en route from producer to consumer. The physical transfer of the goods themselves may or may not be carried out through the same channels. But ordinarily the goods pass along the same channel as does the title. A few of the more common channels of distribution used in the sale of manufactured products to final consumers are illustrated in Figure 1-2. Manufacturer A sells directly to consumers. Manufacturer B sells to wholesalers as well as to retailers. The goods sold are delivered to the middleman who bought them, wholesaler or retailer. Manufacturer C sells to wholesalers and to retailers, but the products he sells directly to retailers are delivered from wholesaler stocks. Manufacturer D sells only to wholesalers. Manufacturer E sells some

products to wholesalers, but he also sells to retailers from his own wholesale branches and makes deliveries to these retailers from stocks kept in the branches. Manufacturer F sells and delivers a part of his output to retailers through his wholesale branches. He also sells to consumers through his own retail stores, and delivers stocks to these stores from his wholesale branches as well as directly from his factory.

It is evident that title may be transferred by direct purchase and sale between producer and consumer. This is the procedure shown for Manufacturer A in Figure 1-2. It is common in the sale of some raw materials to manufacturers, and in the case of goods sold in large quantities by one manufacturer to another. Steel mills, for example, usually sell directly to those manufacturers who use steel in large quantities; and in parts of the South, some cotton is sold to local mills by growers. It is frequently more convenient and more economical, however, for producers to use those specialized agencies known as "middlemen."

Middlemen

Business organizations that specialize in carrying out the transfer of title between producers and consumers are known as middlemen. Their chief functions are to buy and sell or to assist in transferring title between sellers and buyers. But they usually carry on other marketing functions as well. In their buying and selling operations they may, or may not, take title to the goods. They are, indeed, commonly classified on the basis of their relation to the transfer of title. Those who buy goods outright, and thus take title, are "merchant middlemen." Those who assist directly in bringing about the transfer of title, but who do not themselves take title, are called "agent middlemen," or "functional middlemen." Their efforts are directed primarily toward expediting or making more convenient the exchange of ownership. Jobbers, wholesale receivers, and retailers are the most common of the merchant class. Brokers, selling agents, and commission men are examples of agent middlemen.[13]

A third group of agencies should also be distinguished. They are the "facilitating agencies": the individuals, firms, and corporations that specialize in the performance of a part or all of the work involved in one type of marketing activity. Advertising agencies, railroads, public warehouses and cold storage plants, inspectors and graders, banks, and insurance companies are typical examples. Such agencies serve producers, middlemen, and consumers in a

[13] The operations of these types of middlemen will be discussed in subsequent chapters.

specialized capacity. They are not, however, properly called middlemen. It leads to clarity of thought to confine that term to those engaged in direct assistance in the transfer of title.

APPROACHES TO THE STUDY OF MARKETING

Three basic approaches are customarily used in describing and explaining the marketing system: the commodity, the institutional, and the functional. The commodity approach undertakes the detailed study of the marketing of typical or representative commodities, or of classes of commodities, to ascertain the differences in marketing methods, services, and problems. The institutional approach studies the various marketing institutions, particularly the middlemen that perform the marketing task. The functional approach is concerned with an analysis of the major activities, or functions, of marketing that must be performed by the marketing system.

All of these approaches are of considerable importance in the study of marketing, and an introductory marketing book will of necessity make some use of each approach. For example, the following three chapters will undertake to outline the system used in the marketing of the various broad classes of commodities, and later chapters will be concerned with retail, wholesale, and other marketing institutions. The functional approach, however, is the most useful for our purpose, since the marketing functions must be performed regardless of the commodity involved or the marketing agencies used.

A knowledge of the marketing functions is necessary to show how the major processes of marketing—concentration, equalization, and dispersion—are carried on. So important are these functions to the marketing processes that an understanding of them offers the best approach to the solution of many of the problems involved in marketing. This knowledge also enables one to understand why middlemen exist, why marketing is costly, and why certain marketing institutions and techniques have developed. The functions are performed largely by businessmen whose ultimate objective is to earn a profit. It is, consequently, the cost of performing these functions that makes up the cost of marketing, and it is the performance of these functions that constitutes the work of middlemen. In fact they were originally called the "functions of middlemen." [14] But they may be, and often are, performed by producers and by consumers.

[14] In the first published analysis of these functions they were called "the functions of middlemen." See A. W. Shaw, "Some Problems in Market Distribution," *Quarterly Journal of Economics*, August 1912, pp. 703–65. This article has been condensed and reprinted in Hugh G. Wales (ed.), *Changing Perspectives in Marketing* (Urbana: Uni-

THE MARKETING FUNCTIONS

A marketing function is "a major specialized activity performed in marketing."[15] Many such specialized activities could be listed here, but it seems desirable to restrict the number to the eight indicated. Each of these marketing functions will be discussed briefly in this chapter, but a more thorough analysis will be undertaken in later chapters. For purposes of discussion, they can be conveniently classified as follows:

A. Functions of exchange
   1. Selling
   2. Buying
B. Functions of physical supply
   3. Transportation
   4. Storage
C. Facilitating functions
   5. Financing
   6. Risk-taking
   7. Market information (its collection, communication, and interpretation)
   8. Standardization

Functions of Exchange

In the process of transferring ownership the two important functions of selling and buying can be distinguished. These are, in reality, complementary functions leading up to and accomplishing the transfer of title, but the viewpoint of each is different. The purpose of selling is to create demand for a particular product and to find buyers to whom it can be sold at a price satisfactory to the seller. The purpose of buying is to procure the variety, quality, and quantity of goods the buyer desires, to have them ready for his use at the proper time and place, and to obtain them at a price which is satisfactory to him.

versity of Illinois Press, 1951), pp. 32–54. In 1917, L. D. H. Weld enlarged Shaw's concept with a consideration of "marketing functions." See his "Marketing Functions and Mercantile Organization," *American Economic Review*, June 1917, pp. 306–18. For more recent appraisals and criticisms of the functional idea, see references at the end of this chapter.

[15] *Marketing Definitions, op.cit.*, p. 16.

Selling. A basic task of marketing is to bring seller and buyer together. This may be done directly or through their representatives. It is essential because, no matter how great may be the desire of the one to sell and of the other to buy, no exchange can take place until each knows of the desire of the other.

The function of selling, in its broadest sense, involves a number of subsidiary functions, as follows:

1. The function of product planning and development. The seller must offer a product that will satisfy the needs and desires of buyers. He must decide exactly what type of product to produce and when to produce it. He must have it available when the buyer wants it and at a price that the buyer is willing to pay. In part, product planning may be considered to be a production function, but obviously it is of great importance to marketing. A satisfactory product is the starting point of all marketing effort. The product planning function has often been designated as the function of "merchandising." The latter term, however, is used in so many ways that we shall not employ it here.[16]

2. The contactual function. This involves the seeking out and locating of buyers by the seller, the making and maintaining of contacts with buyers.[17]

3. The function of demand creation. This includes all special efforts used by sellers to induce buyers to purchase their products. In the American economy, the impetus to the exchange of title for particular goods falls in large part on the seller. Because most businessmen desire to increase their sales volumes, demand-creational efforts are widespread—including the use of personal selling, advertising, and other devices.

4. The function of negotiation. The terms and conditions of sale must be negotiated between seller and buyer. These terms of sale include such

[16] The Committee on Definitions of the American Marketing Association defines "merchandising" as "the planning and supervision involved in marketing the particular merchandise or service at the places, times, and prices and in the quantities which will best serve to realize the marketing objectives of the business." It goes on to state that the term has been used in various ways and that the recommended definition describes essentially the activity of merchandise, or product, planning. See *Marketing Definitions, op.cit.*, p. 17. See also Edmund D. McGarry, "Some Functions of Marketing Reconsidered," Chap. 16 in Reavis Cox and Wroe Alderson (eds.), *Theory in Marketing* (Homewood, Ill.: Irwin, 1950), esp. pp. 270–1.

[17] The first use of the term "contactual function" was by Ralph F. Breyer in *The Marketing Institution* (New York: McGraw-Hill, 1934). Breyer, however, recognized only two functions, the contactual and the negotiatory. For a discussion of Breyer's ideas, see E. D. McGarry, *op.cit.*

things as quality and quantity of product, price, time and method of shipment, time and method of payment, and many others.

5. The contractual function. This involves entering into the final agreement to sell, including the transfer of title.[18]

Thus it is evident that selling is an all-important function. At all stages in the marketing process it is commonly necessary for someone to sell. This may be a very simple process or it may be, and frequently is, involved and costly.

Buying. The function of buying consists of those activities involved in assembling goods under a single ownership and control. Its immediate purpose is to bring commodities together where they are wanted for use in production or in personal consumption. It results from the buying efforts of businessmen and consumers, and it is important to understand that it involves ownership and control of goods rather than their mere physical concentration. As in the case of selling, certain subsidiary functions of buying may be designated:

1. The function of planning assortments. As the seller must adapt his product to buyers' needs so buyers must do the planning necessary to determine their needs. Business buyers must study their own markets in order to know the type, quantity, and quality of goods desired; and ultimate consumers, in turn, must make similar determinations regarding the assortments of products that they wish to possess.

2. The contactual function. This involves the searching for sources of supply. Although we tend to think of the seller as taking a considerable portion of the responsibility for the contactual function, it is often necessary for the buyer to seek out vendors who can supply a certain product or service. This is particularly true of the ultimate consumer's buying at the retail level.

3. The function of assembling. Stocks of goods must be brought together for use in production or trade by manufacturers, wholesalers, and retailers, or for personal consumption by final consumers. Modern conditions of production, marketing, and consumption make assembling an important activity. Goods produced in many areas, often at a great distance, must be assembled in the right quantity and quality, at the right place and time, and at the right price.

4. The function of negotiation. The terms and conditions of purchase must be negotiated with the seller.

[18] McGarry combines these last two functions into one called the "termination function." See *Theory in Marketing, op.cit.*, pp. 272–?

5. The contractual function. Final agreements are made and the transfer of title takes place.

Buying and selling then are the complementary functions around which all marketing effort revolves. They are basic to the entire marketing process. The foregoing discussion outlines the general nature of these two functions. In subsequent chapters, we shall discuss them in greater detail.

A Note on Pricing. Some students of marketing consider pricing to be a separate function,[19] but it is such an essential part of buying and selling that it seems best to treat it as a problem rather than as a function. This, however, in no way denies its importance to marketing; on the contrary, it is a problem of great importance throughout the marketing system. Goods and services are bought and sold at a price, but back of that price may be a long line of executive decisions, and prices themselves may be expressed in many ways. The problems of pricing will also be discussed in later chapters.

Functions of Physical Supply

The physical transfer of products from producer to consumer is accomplished by means of the highly specialized and technical activities of transportation and storage. Transportation is the movement of products from their sources to the place of consumption, and storage is the holding of products from the time their production is completed until the time of their consumption.

Transportation. It is a commonplace of industrial history that improved transportation makes possible large markets, large-scale production, and specialization in industry. It has increased the variety of goods available for consumption, and has reduced the cost and increased the speed of their physical distribution. In our modern industrial life, this service of taking goods from the place at which they are produced to the place at which they are to be consumed has attained great importance.

Storage. Storage is likewise essential to marketing, especially to the process of equalization. Its function is to hold and preserve stocks of goods from the time of production to the time of use. Since these times are seldom synchronized, businessmen find it necessary to accumulate inventories. Nearly all goods must be stored at one or more points in the journey from producer to consumer. Storage makes it possible for goods that are produced seasonally to be used throughout the year; goods produced "for the market" can be held until there is a demand for their use; products required for use during

[19] See, for example, McGarry, *op.cit.*, p. 271.

short periods can be produced over longer periods of time; perishable commodities can be preserved over relatively long periods; manufacturers can have raw materials stored ready for use; and products can be held for a higher price.

The foregoing discussion shows the necessity for the transportation and storage of products and indicates their importance to industry. It is obvious that while the functions pertaining to the exchange of title are of predominant importance in marketing, they can be made effective only through the functions of physical exchange.

The Facilitating Functions

Four other functions are involved in marketing: financing, risk-taking, the collection, communication, and interpretation of market information, and standardization.

Financing. Modern marketing requires vast resources in machines, materials, land, and men, and large quantities of goods must be held in storage for future use. Moreover, normal marketing procedure involves the widespread extension of credit to buyers. To meet these demands of our marketing system the control of capital is necessary, and the means by which this capital is supplied is called "financing." A familiar situation is found in the case of the man who is fitted for running a retail store but who is without financial resources. At the same time there are others who have the resources but lack the time, the desire, or the ability to undertake the project. Means have been developed to bring these together. Another illustration is found in those lines of business in which there are seasonal peaks in marketing during which much larger capital sums are needed than at other seasons of the year. Firms engaged in marketing such products must be possessed of large financial resources in order to meet the demands of these recurring periods. Or, being without sufficient capital, they must attempt to borrow it. Other businessmen who could accumulate sufficient funds to meet all such peak loads may prefer to invest their accumulations in extensions of their business, or even to invest elsewhere. Otherwise such surplus funds can be utilized to advantage only a part of the year and may remain unused drawing no return for the remainder of the time. To meet such problems as these is the function of financing.

Risk-taking. The entire marketing process by means of which goods are taken from producer to consumer involves risk. This risk is assumed by those who take part in marketing, and particularly by those who take title to goods. There is risk of loss from fire, flood, storm, theft, deterioration, and from

bad debts or general financial difficulties outside the control of the individual. Fashions may change or the market may be misjudged, leaving unsalable products in the hands of those who have produced or purchased them for sale. Increased supplies, reduced demand, or changes in the value of money may change the prices of commodities. Some of these risks can be wholly or partly insured against, or the burden can be shifted to the shoulders of those who specialize in bearing them. With many others, however, the businessman must himself contend. The means by which these risks are insured against, shifted, and borne is an important phase of marketing.

Market Information. Also important to marketing is the collection, communication, and interpretation of market information. This includes the gathering and interpretation of such facts as may be thought to have a bearing on what products are available, what sellers plan to sell, what buyers will purchase, the quantities available, and the prices that sellers and buyers are willing to receive or pay. Above all, modern marketing requires data about the market itself: the number of consumers and their location, their purchasing power, their product and brand preferences, their motivations, and many other similar items of information.

Many of the major decisions that businessmen must make are based on their interpretation of the available market data. Whether to go into business, what the business shall be, and where it shall be located; where to sell and by what means; whether to modify existing products and marketing methods to meet the demands of existing or changing market conditions—these and many other marketing problems are answered on the basis of the businessman's interpretation of the available market information. His information may be meager, or it may be based on carefully collected data interpreted after a thorough analysis based on the most advanced methodology.

To be effective in bringing about a proper regulation of the flow of commodities into the channels of trade, market information must be accurate, adequate, and promptly available to all parties involved in its use, and it must be properly interpreted by those who use it.

Standardization. Standardization is the general term which includes the establishment of standards for products, the inspection of products in order to determine the standards to which they conform, and, where necessary, the sorting of products into lots conforming to established standards. The last two activities are commonly called "grading." It is evident that the three activities are closely related and have as their objective the attainment of the advantages to be derived from marketing standardized products. Thus we include them under the one term "standardization."

Standardization is an important marketing function because standardized

products are more easily purchased and sold. When products are known to be of uniform quality, size, and type, and when these characteristics conform to recognized standards, the consumer can purchase them with confidence that they will meet his needs. When products are not standardized, however, they must be carefully inspected by the buyer, checked for quality and suitability, and perhaps tried on for size. Even after all this, and regardless of the care with which the purchase is made, they still may be found to be unsuitable at a later date and may have to be returned to the seller and exchanged for a more appropriate item. Transactions involving nonstandardized products are expensive in time and money to both buyer and seller. And yet much remains to be accomplished in our marketing system with respect to the standardization of goods, especially those sold to the ultimate consumer.

SUMMARY

Marketing is an important and complex aspect of the American economy. Its ultimate objective is to provide the consumer with the goods and services necessary to satisfy his needs and desires. This objective is accomplished through the marketing efforts of many producers, wholesale and retail middlemen, facilitating agencies, and even consumers themselves. The work of marketing is carried on through the processes of concentration, equalization, and dispersion and involves the performance of the marketing functions. It is evident that these functions must be performed and that their performance involves expense. These expenses make up the cost of marketing, a cost which, added to the cost of production, goes to make up the total cost of the product that is sold to consumers. All of these functions do not necessarily appear in each marketing transaction, and each function may appear at various stages in the distribution of a particular product. But some or all of them must be performed at each step in the marketing of all commodities. Actually the marketing functions are performed in various ways and by various agencies depending upon the type of commodity being marketed and the conditions of its production and consumption. In the three following chapters, we shall outline the marketing system and show how its structure is affected by commodity characteristics.

QUESTIONS FOR DISCUSSION

1. Compare the definition of marketing used in this book with the definition given in footnote 5. What are the significant differences between them?

2. Paul Mazur has stated that marketing is the delivery of a standard of living. Discuss the implications of this statement and its usefulness as a definition of marketing.
3. If Peter Drucker is correct in his contention that present underdeveloped countries would benefit immediately by the development of an efficient marketing system, even though the manufacturing system itself may not be efficient as yet, how do you explain the fact that efficient marketing systems have always developed after efficient manufacturing systems and not before?
4. Show how each of the marketing functions relates to and assists in the performance of the processes of concentration, equalization, and dispersion.

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2. MARKETING MANUFACTURED CONSUMER GOODS

For the purpose of the ensuing analysis, three classes of products may be distinguished: manufactured goods, natural raw materials, and agricultural products. Manufactured goods may be further subdivided into consumer goods, which are destined for use by the ultimate consumer, and industrial goods, which are purchased by business buyers. Natural raw materials, of course, are industrial goods since they are the products of the mine, forest, and sea which undergo processing operations prior to final consumption. Agricultural products include both raw materials for industry, such as cotton, wool, and grain, and consumer goods, such as fresh fruits and vegetables, which are transferred to the ultimate consumer in their original form. Each of these classes of products has its own particular marketing structure, a structure which is especially adapted to the characteristics of the products involved and which differs at least in some degree from the marketing system used for the other classes of goods. The marketing of these various types of products will be outlined briefly in this and the two following chapters.

CHARACTERISTICS OF MANUFACTURED PRODUCTS

The marketing of manufactured products, both consumer and industrial goods, tends in certain respects to be a somewhat less complex process than that for agricultural products. The channels of distribution generally require the use of fewer middlemen, since the process of concentration is less involved. The producer of manufactured goods exercises much more control over the marketing of his product than does the producer of agricultural goods. The reasons for these and other differences lie primarily in two characteristics of

manufactured products and of their production: (1) the fact that the manufacturer has a large degree of control over the quantity and quality of his product, and (2) the fact that production usually takes place on a larger scale than does agricultural production.

Control of Quantity and Quality

The production of manufactured goods can be closely adjusted to the actual and anticipated market demand. If the market requires a certain quality of product, the manufacturer can usually provide it. He can also determine the quantity that he will produce and is thus able to plan in advance his production, marketing, and financial operations.

This control over the quantity of production represents a substantial advantage to the producer of manufactured goods, and one that is not equally available to the producer of agricultural commodities. Because of this control, the manufacturer is in a position to exercise a greater degree of influence on the price of his product than can the individual agricultural producer. In a declining market, production will be curtailed in an effort to balance supply and effective demand, to prevent market gluts, and to maintain at least some degree of price stability. In a rising market, efforts will be made, within the limits of plant capacity, to increase production to meet the demand. Although manufacturers are not always completely successful in these efforts, it is true that the prices of manufactured goods tend to change less rapidly than do the prices of agricultural products despite the fact that substantial effort has been made for a number of years to stabilize agricultural prices through governmental action.

As a result of the fact that quality is subject to close control, most manufactured products are standardized as they come from the factory. It follows that the expenses of standardization as a marketing function are reduced to a minimum. There exists, moreover, on the part of most consumers a high degree of faith in the integrity of manufacturers. This permits the latter to brand their products and thus to exercise a certain amount of market control. Branded products can be readily identified, and if uniform quality is maintained by the manufacturer, consumers who have derived satisfaction from the use of these products in the past will tend to buy them again. The desire to create and maintain this consumer good will induce the manufacturer to attempt to produce goods of uniform quality, and the conditions of production make it possible.

Large-Scale Production

Manufacturing operations tend to be conducted on a large scale, especially in comparison with agricultural operations. This does not mean that all, or even the majority of, manufacturing firms are large; in fact the majority are ordinarily classified as small. Neither does it mean that all agricultural operations are small, particularly since the size and productivity of farms have increased significantly over the years and presently are rising at a rapid rate.[1] But it does mean that most manufacturing is conducted on a sufficiently large scale so that some control can be exercised over the marketing methods used, and most firms can market their products efficiently prior to the beginning of the dispersion process without combining them with the products of other firms. Thus manufactured goods generally need not be concentrated. It is true, as we shall see later, that small manufacturers sometimes turn over to a specialized agent middleman the entire task of marketing their products. This is somewhat exceptional, however, and usually does not involve the physical concentration of the products. Accordingly, the marketing of manufactured goods is concerned more with the dispersion process than it is with the concentration process.

The growth of large-scale production, however, has had even more important effects upon marketing. Individual manufacturers have found it necessary to use aggressive marketing methods in order to sell the output of their factories. Large-scale production has also brought a clearer recognition of the importance of operating plants continuously in order to meet fixed expenses and to keep the organization together. This often has resulted in tremendous pressure on the marketing and sales organization to sell more goods. The efforts that have been made to accomplish these purposes have had numerous effects, of which three are particularly pertinent to the present discussion. These are (1) the effect upon integration and combination, (2) the effect upon competition and product differentiation, and (3) the effect upon direct marketing.

Integration and Combination. In their efforts to achieve even greater size and market control, business firms have tended to integrate and combine their operations with those of other firms. This integration and combination has been both vertical and horizontal in character.

In *vertical integration* or combination, operations in successive stages of

[1] It may be noted also that, as agricultural operations have attained a greater scale, the marketing methods used for agricultural products have tended to approach more closely those of manufactured goods. See discussion in Chap. 4.

production or marketing or both are carried on under a single ownership. For example, a steel manufacturing firm may own its own iron ore and coal mines, these commodities being the basic raw materials used in making steel. Or an automobile manufacturing company may acquire or establish a tire manufacturing plant. From the marketing viewpoint, vertical integration takes place when a manufacturer establishes his own wholesale warehouses and undertakes to sell directly to the user or retailer. A chain store system has integrated vertically when it performs its own wholesaling operation and when, as is true of many chains, it purchases or establishes manufacturing plants to produce commodities that are sold in the chain's retail outlets. Vertical integration in marketing will be further discussed in the subsequent section on direct marketing, but it is evident from even this brief review that the integrated operation has no selling problem so long as the product remains within the organization. It should be understood, however, that some companies permit operating divisions to purchase from sources outside the organization if there is a cost or service advantage in doing so.[2]

The advantages of vertical integration presumably arise from the fact that both production facilities and marketing operations can be more effectively coordinated than is possible when manufacturing plants and marketing agencies are independently owned and operated. To the extent that this is true, there exists a relationship between the various elements of the integrated organization which may lead to economies in production, buying, transportation, storage, research, and financing. And, with effective synchronization between demand and supply, it is possible that there is some reduction in the amount of market risk incurred. The extent to which these economies exist, or whether they exist at all in many instances, has not been clearly demonstrated. Nevertheless, there is a great deal of vertical integration in our present economy.

Horizontal combination refers to the combining of plants and business operations which manufacture and market similar products. The products may be identical, or directly competing products, or they may be goods which are not directly competitive but which are commonly used together or sold through the same type of outlets. This latter type of horizontal combination is sometimes called "circular" or "complementary" combination. When many of the articles produced are not closely related, the term "collateral" combination is sometimes applied. The extent to which horizontal combination exists in our economy is so great that every reader can cite

[2] For a complete discussion, see Nugent Wedding (ed.), *Vertical Integration in Marketing*, Bull. No. 74 (Urbana: Bureau of Economic and Business Research, University of Illinois, 1952).

numerous examples. The large automobile manufacturing companies are illustrative: a single firm manufactures and sells various makes of cars that are competitive in price with one another, as well as other makes that are complementary as to price line. In addition, it manufactures products other than automobiles, thus illustrating circular and collateral combination. In recent years, specialized appliance manufacturers have tended to combine horizontally in order that they might offer a full line of products to dealers and distributors. Manufacturers of toiletries and beauty preparations have followed a similar pattern, and the producers of industrial chemicals have even entered the consumer goods field with new and specialized products.

The extent to which manufacturing economies result from horizontal combination is not always clear. In fact, unless the plant facilities used in manufacturing each of the products are of an optimum size and are operated at optimum capacity, manufacturing costs may be higher than those of more highly specialized competitors. There may be economies in financing and in purchasing important materials, and the cost of expensive industrial and marketing research may be less per dollar of sales. Marketing economies may also result. It is frequently found, for example, that a variety of products can be marketed at a lower unit cost than is possible for single items in the line. The expense for salesmen and advertising can be spread over a wider line, and economies in other marketing operations, including warehousing and transportation, may result. It is often possible for the multiple-item manufacturer to avoid dependence on wholesale middlemen or to obtain more effective cooperation of both wholesalers and retailers than can manufacturers of single items.

In spite of the advantages that may be realized, problems of operation and control in both production and marketing are complex. There is, for example, a limit to the number of items an individual salesman can sell effectively. Salesmen must be carefully trained and controlled, and since a wider line must be sold each call takes a longer time; thus a large sales organization is essential. Many companies selling a wide line of products have found it necessary to develop specialized sales organizations to sell single products or groups of products. This is partly due to the difficulty found in training one salesman to know enough about the complete line to sell it effectively. Another reason is that many of these large organizations sell to several different classes of purchasers, such as retailers, wholesalers, institutions, and manufacturers. Special knowledge of the needs and problems of particular types of purchasers often calls for a degree of specialized knowledge which it is impossible for a general-line salesman to acquire.

The development of the chain store in retailing and of multiple-unit

operations in wholesaling are also examples of horizontal combination. There are obvious marketing advantages resulting from combinations of this type. Buying activities are likely to be carried on more advantageously, and quantity discounts are usually obtainable on large purchases. Many other economies of large-scale operation may be realized. Advertising and other methods of sales promotion may also be carried on more effectively. As in the case of manufacturing combinations, however, problems of operation and control become more difficult in the large marketing organization. More layers of management are required, thus increasing overhead costs. Obtaining and controlling personnel presents a substantial problem, and it is difficult to adapt operations to the particular needs and problems of each local market. Thus there are both advantages and disadvantages to multiunit marketing organizations, and these will be discussed at considerable length in Chapters 9 and 12, but there can be no doubt that such organizations have had a tremendous impact upon the marketing system.

Combinations then have been formed for various reasons: to alleviate competition, to obtain economies in production, to afford a broader base for financing, to obtain marketing advantages, and for many other reasons. But regardless of the reasons for their formation, they have had an important effect upon marketing, not only through their influence on competition but on marketing methods as well. The intensity of competition, at least in certain respects, has been both impaired and enhanced by horizontal combination. In some cases the number of firms in an industry has been reduced to such an extent that the degree of competition has undoubtedly been impaired, but in other instances the replacement of several formerly weak competitors by one strong organization has served to increase the intensity of competition, at least for a time. In addition, horizontal combination has resulted in carrying out marketing operations on a larger scale, in increasing the amount of direct marketing, and in utilizing sales promotional methods that would not be economical for the small firm.

Competition and Product Differentiation. Competition of one type or another is an important aspect of our economy and of the marketing system. Competition may be directed toward the improvement of production and marketing methods, the reduction of costs, and the lowering of prices, although it does not necessarily follow that prices are always lowered as costs are reduced. On the other hand, competitive effort often is directed toward product improvement and the use of sales methods that will result in greater control over the market. Both types of competition are important for manufactured goods. But it is a distinguishing characteristic of the marketing of such products, as compared with the marketing of natural raw materials and

agricultural products, that considerable emphasis can be placed upon the product and sales promotional aspects of competition.

Actually individual manufacturers, since they operate on a relatively large scale, are in a better position to help themselves than are most individual farmers. Efforts to improve methods and reduce costs are carried on with more determination and usually result from their own study and experimentation, unlike the situation in agricultural products where the research is more likely to be carried on by government with the results available to all producers. Large manufacturers, in particular, place great emphasis on developing new products and improving existing ones, on differentiating them from competing products, and on identifying them by the use of brand names. Thus, whereas the major result of competition in the sale of raw materials and agricultural products is manifest in the price area, we find that, although competition in the sale of manufactured products is also evident in the price area, it is to a large degree carried out through the sale of differentiated products which are branded by manufacturers and middlemen. This is particularly true of consumer goods, in the sale of which carefully planned marketing efforts are utilized with a view to creating demand for the differentiated products. Thus, in greater or lesser degree, competition is taken out of the price area and into the quality area—creating demand for particular products which can be sold without the necessity of meeting the exact prices of competing goods.

Direct Marketing. Because of the competition for markets, many manufacturers find it desirable to control their marketing operations and to keep in close touch with all the conditions that may affect the demand for their products. There is, consequently, a constant tendency toward direct marketing, the elimination of one or more middlemen in the channel of distribution. It is true that the feasibility of direct marketing is dependent upon a number of factors, but size and its concomitants are of major importance. Most small manufacturers cannot market their products directly, but the large producer with adequate financial resources can frequently distribute directly to industrial purchasers or to retail stores. And, if direct marketing is not entirely feasible, it may at least be possible to exercise a high degree of control over the efforts of the independent middlemen and agencies whose services are utilized.

The extent to which he will perform the marketing functions himself and the degree to which other marketing agencies will be used is a constantly recurring problem to the average manufacturer.[3] This is particularly true of

[3] The general problem of direct marketing and manufacturer-middleman relations will be discussed in Chap. 15.

his relations with middlemen. Thus he may create a demand for his product through the use of his own sales force, or by advertising, or he may depend on middlemen entirely. He may also utilize a combination of his own agencies with those of middlemen, depending in part on his own efforts and in part on those of middlemen. He may, in other words, cooperate with the middlemen who sell his product and depend on this combination of efforts to sell his goods. Manufacturers of both consumer and industrial goods use wholesale middlemen; but there are many exceptions, as for example, manufacturers who do their own wholesale selling and who perform all wholesale operations through their own marketing organizations. Practically all manufacturers of goods for personal consumption use the retailer. But there are important exceptions even here, such as the house-to-house sale of some household products, books, and clothing, and the ownership of retail outlets by some manufacturers of shoes, automobile tires, and gasoline.

MANUFACTURED CONSUMER GOODS

Characteristics of the Market

It is probably safe to say that the greatest variety of marketing problems, and perhaps the most difficult problems, are found in marketing goods for personal consumption. To the extent that this is true it is due to the special characteristics of the market for such commodities. Consumer goods are sold for use by final consumers wherever people are found. In domestic trade, this means all of the people in the country. These consumers are unknown to the manufacturer, but they normally expect to purchase when the need or desire for goods arises, and without previous notice. Such purchases are made in small amounts and for the gratification of the needs of particular individuals. The purchasers are generally unskilled in buying, and there are few recognized standards to aid them.

Buyers Are Numerous and the Market Widespread. Consumer goods are sold wherever there are people with purchasing power who have a desire for the product. This means that the market for consumer goods is widespread.[4] Many manufacturers, of course, limit the market area in which they operate, but nevertheless their potential customers are numbered in thousands and even in millions. In order to serve such a large number of potential buyers, it is necessary for the manufacturer to select carefully his channel of distribution. In most cases, he must rely on retail stores to make his product

[4] The consumer market is analyzed more specifically in Chap. 5.

available to the ultimate consumer, and in many instances he will utilize wholesalers to sell to the retailers. Any other method used to serve so many buyers would prove to be either ineffective or too expensive.

Unit of Purchase Is Small. Individual consumers tend to buy in small amounts and often at frequent intervals. For this reason and also because buyers are so numerous, the manufacturer is forced to use "mass methods" of selling. Not only must he make sure that his product is available at many convenient points of purchase, but in addition he must create a demand for his product. It is often necessary for the manufacturer to broadcast sales appeals through media that can be expected to reach large numbers of potential buyers. Mass methods of selling include the use of advertising in newspapers and magazines, on billboards and over radio and television; the house-to-house distribution of samples; the demonstration and display of articles on a wide scale; and distribution in retail stores. There are, of course, exceptional cases when the amount of the individual sale warrants the direction of sales effort to particular individuals because it appears that the profit on an individual sale will be large enough to warrant the expense involved. But as a rule mass sales efforts are more economical.

Buyers Are Poorly Informed. Since ordinary consumers buy a great variety of merchandise in small quantities, they are not inclined to take time to examine the less important characteristics of competing products, and they seldom become skilled buyers. And of fundamental importance is the fact that not only do consumers seldom attempt to become skilled buyers, but even when they have the inclination to do so there are few recognized standards to aid them. They must, consequently, depend in large measure on the statements of those from whom they buy. That is, they must depend on such statements until they have thoroughly tried the article. And even when they can determine the qualities of a product through trial, they are still dependent on the producer's ability and intention to produce similar products in the future. Furthermore, goods for personal consumption are used to satisfy intangible desires, and the characteristics which gratify such desires cannot usually be subjected to close examination and measurement. The same physical characteristics appeal to individuals differently, and to a single individual their appeal may vary from time to time. Again, it is in the field of personal consumption that so many new products designed to gratify new and often unrecognized needs, as well as new or changed products to meet well-known wants, are found. Consumers must be told about these products. Demand must be created. All of these conditions make the consumer particularly susceptible to demand creation.

Personal Considerations Guide Purchaser. Because consumers buy for personal gratification, the conditions which surround the sale often assume great importance. Service is particularly significant to some purchasers. For them service is a part of the product, a part of the thing they are buying. In such cases, the cost of the service is usually included in the price of the product. The prices for identical commodities, for example, are usually higher in a store that emphasizes service than they are in one that does not. So far as the manufacturer of consumer goods is concerned, the important thing is to have his product available in those outlets, whether they emphasize service or not, at which the consumer desires to buy. For some products, such as durable equipment, it may be important for the manufacturer to ascertain that adequate repair and other forms of service are available in the local community.

And finally, although price is important in the sale of consumer goods, it is usually of less relative importance than in the sale of industrial goods. But here we must generalize with care. In the sale of some staple products, such as sugar and flour, price may be and usually is of great importance; whereas with furniture and clothing, for example, more emphasis may be placed upon style, suitability, and quality. Moreover, differences in income affect the attitude which different individuals have toward price. A dollar more or less in the price of an item may make little difference to one with a large income, while it may make all the difference between buying and not buying to one with a small income.

Classes of Consumer Goods

It is commonly stated that the object of all production is consumption, and it is evident that if we consider our economy as a whole the ultimate aim is the production of goods and services for use by final consumers. Because consumer goods are generally bought in relatively small amounts in retail stores, the machinery used in marketing them has been developed around the retail store. But the ways in which consumers purchase goods at retail vary considerably. These differences in consumer purchasing habits are the chief basis for the classification of consumer goods into convenience goods, shopping goods, and specialty goods.[5] No single product can be said to fall

[5] This classification and that for industrial goods which is used in the following chapter were developed by Melvin T. Copeland in "Relation of Consumers' Buying Habits to Marketing Methods," *Harvard Business Review*, April 1923, pp. 282–9, and were treated further in his *Principles of Merchandising* (Chicago: Shaw, 1924). Although new concepts of consumer convenience have been developed in more recent years, the Copeland classification still has considerable merit for certain marketing applications. For further dis-

in any one of these classes for all purchasers. But the degree to which those who have consumer goods to sell to retail stores, particularly manufacturers, *think* their products fall into these classes for large groups of final consumers greatly influences the manner in which they are marketed. This last statement points to a weakness in this classification which must be guarded against. It may help, but it may also lead the manufacturer astray, unless he takes care to use it simply as an aid in studying the relation of his product to his market.

Convenience Goods. The purchase and sale of convenience goods have certain definite characteristics. Consumers prefer to purchase them on short notice, with a minimum of effort, and, most characteristically of all, at a convenient location. They are generally articles of small value used frequently by those who purchase them. Certain drug and hardware products, groceries, meats, ice cream and beverages for immediate consumption, some toilet articles, tobacco products, newspapers, magazines, and gasoline are common examples. Nearby stores, consequently, or stores which are passed regularly in going to and from work or for some other reason, usually offer convenient places for purchase. It is not usually worth the consumers' time to shop from one store to another for such goods. Many are branded and others, although not branded, can be purchased with reasonable assurance from dependable dealers.

From the point of view of the retailer, convenience goods are those for which demand is regular and continuous, and he is chiefly concerned with keeping a supply on hand, with offering a convenient service, and sometimes with having an attractive display. Quality, and frequently price, are standardized, and consequently it does not usually require a very skilled type of salesmanship to sell convenience goods to consumers. Very often the retailer carries several brands of a given type of convenience good and devotes little or no time to promoting the sale of any one of them.

The manufacturer of convenience goods usually meets with intense competition for sales. In order to sell his product successfully, he must make sure that it is available when the consumer wants it, and he must devise means to induce the middlemen to carry his product in stock. If not available when wanted, it may not be purchased at all; for the consumer will purchase a competing brand or a substitute product or go without it for the time being. For this reason it is necessary to have convenience goods available in as many stores as possible in order to avoid loss of sales. Limited or exclusive agencies are seldom used.

cussion, see Eugene J. Kelley, "The Importance of Convenience in Consumer Purchasing," *Journal of Marketing*, July 1958, pp. 32–8; and Reavis Cox, "Consumer Convenience and the Retail Structure of Cities," *Journal of Marketing*, April 1959, pp. 355–62.

Because of this need for wide distribution in retail stores and because many retail stores sell such products in small volume, the manufacturer has a difficult marketing problem. It would require a large marketing organization and would usually be too expensive for him to market directly to retailers; so he typically sells such goods through wholesale middlemen. If his products are branded, he often finds it necessary not only to make his products attractive to consumers, but to carry on extensive consumer advertising with the object of creating a consumer demand which, in turn, will make his product attractive to the wholesalers and retailers to whom he desires to sell.

Convenience goods comprise, perhaps, the most clear-cut of the three classes of consumer goods. For while it is true that some consumers do shop for convenience goods, in order to save a penny here and there or to compare qualities, such "shopping" is not comparable in its prevalence to that which takes place for shopping goods. And although consumers do not always buy convenience goods at the *most* convenient location, they seldom are willing to travel any great distance to obtain them, as they often do in purchasing specialty goods.

Shopping Goods. As the name implies, shopping goods are purchased with much greater care than are convenience goods, and a final decision is made only after a comparison of several products. Quality, style, suitability, and price are the usual bases of comparison, and a sale depends to a considerable extent on consumer taste. In some instances style is the predominant consideration; with another product or another person, quality or price may assume the greatest importance. Typical examples of shopping goods are furniture, rugs, women's clothing, millinery, and expensive jewelry.

In contrast with convenience goods, shopping goods usually involve a considerable outlay of money, are purchased only after due consideration, and at infrequent intervals. The buyer usually postpones purchase until he has time to shop with care, and he is often willing to go to considerable trouble in order to make a satisfactory purchase. This means that many purchasers, in order to make suitable comparisons, are willing to go to the shopping centers in which stores selling such goods tend to congregate, and they may even make several trips before the purchase is finally made. Thus, if the manufacturer of such goods is to achieve the maximum of sales, he must have his goods available in those stores in the shopping centers in which shopping is carried on. These are, in the main, department stores and the larger specialized stores handling furniture, ready-to-wear, and similar products.

Many shopping goods are not branded, and when they are, the brands are usually not well known and seldom convey a clear idea of the character-

istics the buyer wishes to compare. Thus the buyer must see and compare competing products. They are also goods in which competing stores commonly do not carry identical assortments. Accordingly, the buyer may "shop" for them in two or more stores. Such shopping may be accomplished, however, by comparing the products offered for sale within a single retail store.

The marketing of shopping goods from manufacturer to retailer differs in several important respects from the marketing of convenience goods. The manufacturer is interested in having his goods for sale in the most suitable shopping stores, rather than in having them in every possible outlet. The retailer must exercise great care in stocking only goods which will be wanted by the customers of his particular store. Therefore, since the goods must, to a large extent, be personally selected by the retailer, usually from samples or from the manufacturer's stock, and because sales to individual stores are usually made in large volume, direct sale to the retail store prevails in large measure. The importance of having the "right" goods, and the importance of price, make direct negotiation and sale desirable, and the fact that orders are likely to be large makes direct selling economically possible.

Specialty Goods. Specialty goods are those "which have some particular attraction for the consumer, other than price, which induces him to put forth special effort to visit the store in which they are sold and to make a purchase without shopping." [6] They are usually branded and advertised, and customers are thus able to identify them. They are, furthermore, to a large extent goods the purchase of which involves a considerable outlay on the part of the consumer and the sale of which makes up an appreciable portion of the sales of many of the retailers who handle them. Their successful sale at retail usually requires a large investment in stock, and sometimes, as with mechanical devices, a competent and often expensive service department. Men's ready-to-wear clothing, men's and women's high-grade shoes, fancy groceries, high-grade watches are examples. Automobiles and electrical appliances are sometimes classed as shopping goods and sometimes as specialties.[7]

Although specialty goods commonly bear the brand of a manufacturer, it should be pointed out that, whereas some consumers have such a strong desire to buy a particular manufacturer's product that they will postpone their purchase until they can go to a store which sells it, others have so much confidence in individual stores that they will postpone their purchase until

[6] Melvin T. Copeland, *Principles of Merchandising*, *op.cit.*, p. 103.

[7] Specialty goods are often handled by exclusive agencies which will be further discussed in Chap. 18. New products, novelties, and patented articles are often called specialties. Such products are not here considered as specialty goods unless they have the characteristics discussed in the text.

they can go to the particular store in which they wish to buy. Very often the purchase is made for both reasons, that is, the favored store sells the favored brand. In such cases there are obvious advantages to both manufacturer and retailer, for the retailer can sell to those who come to his store in order to get the manufacturer's brand, and the manufacturer's brand may be sold to those who prefer to buy commodities such as his from that particular store.

The distinction between convenience goods and shopping goods is reasonably clear and is generally accepted, but the specialty goods class is by no means so clear and its validity and usefulness are not so widely accepted.[8] Individual consumers differ in the method used in purchasing many of these articles. Thus some buy automobiles only after shopping for them; others buy the make of car they have already decided upon and go directly to the retail agency which sells it. The automobile is of interest in this connection, however, since it is sold through exclusive agencies—the typical method of selling specialty goods—but, of course, those who wish to shop can call on a number of agencies. Men's clothing is often cited as an example of specialty goods, and is such to many buyers, but others may have no particular brand preferences; some shop and some may go to a particular store at a particular time because that store's advertising has led them to believe it has what they want—a short-cut for shopping.

Another confusing product is the automobile tire. Some buyers shop for tires, some will buy only the brand favored at the moment, others may do a little shopping, and still others may have a favored brand but will not wait long nor spend much time in seeking a store in which that brand can be purchased. Neither will they pay a price much higher than that asked for competing brands of similar quality. As a result, we find some tire manufacturers use exclusive agencies, some use limited agencies, some sell to as many dealers as they can, and some combine the ownership of stores, close cooperation with certain dealers, and a rather wide sale to other outlets.

Conclusions. Products are classified as convenience, shopping, or specialty goods on the basis of the characteristics of their purchase by the majority of consumers. But since these are not always easy to distinguish in the case of particular products, many goods are difficult to classify. The classification is nevertheless valuable. The manufacturer who knows, for ex-

[8] For example, specialty goods have been defined by one writer as "the convenience or shopping goods which face such a limited market that outlets are relatively few, necessitating a 'special purchasing effort' on the part of the buyers." See Richard H. Holton, "The Distinction Between Convenience Goods, Shopping Goods, and Specialty Goods," *Journal of Marketing*, July 1958, p. 56.

ample, that his product may be sold as either a shopping or a specialty good can weigh the market situation more accurately and proceed to a more intelligent course of action. He may, of course, be led astray by too easy generalization, but this classification can be very helpful when supplemented by a detailed study of the characteristics of his own product and its market.

It is safe to say that any manufacturer who brands his products would like to create a demand for them on the part of a sufficient number of consumers to be able to sell them as specialty goods. It is cheaper and more convenient for him to sell to a single dealer or to a limited number of dealers who handle his products in large volume than to sell them as convenience goods to many dealers most of whom sell only a small volume. Such selling is also more desirable than selling products as shopping goods. This is true even though they may be sold to some or all of the relatively small number of shopping stores in any area. If he is successful in creating a specialty demand for his product, the demand of a considerable number of consumers will be focused on his particular product; whereas shopping implies a willingness to buy any product, branded or unbranded, which best meets the buyer's ideas of quality, style, and price.

Moreover, stores selling shopping goods commonly place great emphasis on building a reputation for the store as a merchandising institution, and thus their sales promotion is built about the store name. They are usually large stores that prefer to determine their own sales policies, to control their own advertising, and to minimize or ignore the manufacturer's name or brand. Accordingly, they may not cooperate effectively with the manufacturer in using his ideas of sales promotion, particularly when these are devised to build a demand for his company name or brand. The ideal store for the sale of a specialty product, on the other hand, is one which is willing to cooperate in building just such a demand, and many retailers find it to their advantage to do so.

It is evident from the preceding discussion that goods which the manufacturer thinks he can best sell on a specialty basis will be sold that way, whereas other manufacturers may sell similar products as shopping goods or even as convenience goods. The case of automobile tires has already been cited. Women's hosiery is sold in each of the three ways. Automobiles and electrical appliances are commonly sold through exclusive agencies as specialty goods, but this does not prevent many consumers from shopping for them. Some manufacturers of men's clothing sell their branded goods as specialties, while they and other manufacturers sell unbranded clothing to retailers for resale under store brands.

Channels of Distribution

The most common channels of distribution for manufactured consumer goods are:

1. Manufacturer to consumer.
2. Manufacturer to retailer to consumer.
3. Manufacturer to wholesaler to retailer to consumer.
4. Manufacturer, with the assistance of an agent middleman, to wholesaler to retailer to consumer.

The proportions in which manufacturers of consumer goods market their products through these various channels are not known. Data are available showing the types of customers to whom manufacturers sold their products in 1939 and the proportion of total sales volume sold to each.[9] These data, however, do not reveal exactly sales by channels; and, in any event, sales of consumer goods are not separated from those of industrial goods. With respect to consumer goods, it is probable that less than 10 per cent of the total are marketed with the assistance of agent middlemen and that almost 50 per cent, including a considerable proportion of those commodities handled by the agent middlemen, are distributed through merchant wholesalers. Between 5 and 10 per cent of consumer goods appear to be sold directly from manufacturer to consumer. The remainder, probably about 45 per cent of the total, use the channel of manufacturer to retailer to consumer.[10] These

[9] See *Census of Business*, Vol. V, *Distribution of Manufacturers' Sales, 1939* (Washington, D.C.: Bureau of the Census, U.S. Department of Commerce, 1942), p. 7. Similar data were not collected in connection with the Census of Business of 1948 and only for a few commodity groups in 1954. Manufacturers' sales in 1939 were distributed as follows:

To industrial and other large users	26.0 per cent
To wholesalers and jobbers	25.1
To or through own wholesale branches or offices	22.4
To retailers for resale	19.6
To or through own retail stores	2.1
To consumers at retail	1.6
Export, direct to buyers in other countries	2.3
To export intermediaries	0.9
Total	100.0 per cent

[10] The figure of "almost 50 per cent" for consumer goods marketed through wholesalers is used by Theodore N. Beckman, Nathanael H. Engle, and Robert D. Buzzell in *Wholesaling*, 3rd ed. (New York: Ronald, 1959), p. 89. The figure of less than 10 per cent distributed through agent middlemen is indicated by the data on p. 9 of *Distribution of Manufacturers' Sales*, *op.cit*. With respect to direct sale to the consumer, the data in foot-

figures, although largely estimates, should be sufficiently accurate to give a general idea of the relative importance of the four channels.

Manufacturer-Consumer Channel. The sale of products from manufacturer to consumer is the most direct method of distribution. Although many industrial commodities are sold directly to users, this is the least important channel of distribution for manufactured consumer goods. The reason for this seems obvious: it is simply impossible for the thousands of manufacturers of consumer goods to make direct contact economically with the millions of potential buyers of their products. A few manufacturers do prefer, however, to sell all of their products in this way, and many combine it with other channels.

Three general means of making sales directly by the manufacturer to the consumer are in use: (1) advertising, (2) salesmen, and (3) retail stores owned by the manufacturer. The first method includes the use of local, sectional, or national advertising media, such as newspapers, magazines, catalogs, and direct mail methods; local and national broadcasting and telecasting facilities; and sometimes the use of samples which are sent through the mail. The distinguishing characteristic of this method of sale is that the seller has no personal contact with the buyer through his own salesmen, orders usually being sent by mail.

The second method of direct sale to consumers is by the use of salesmen who are compensated for their services by the manufacturer. In this case, sales are made through personal calls by the manufacturer's representative. The salesmen may, of course, perform functions other than selling, such as delivering the products, making adjustments, and collecting accounts; but their primary work is to sell. Some household goods, brushes, hosiery, and clothing are sold in this way.

Finally, the manufacturer may own his own retail stores. Through them he comes into direct contact with his customers and retails his products to them. Automobile tires, gasoline, shoes, and clothing are sometimes sold in this manner. Bakeries and confectionery stores which make their own products and sell them through their own outlets are also utilizing this method of distribution. It is unusual for a large manufacturer to depend entirely on his own retail stores for his market. His outlets frequently serve, however, as an experimental means of contact with the consumer, or as an assured

note 9 show that 3.7 per cent of manufacturers' sales were made directly to consumers, 2.1 through the manufacturers' own retail stores and 1.6 in other ways. The 3.7 figure refers only to consumer goods but is expressed as a percentage of total consumer and industrial goods. Thus the figure as a per cent of consumer goods only would be perhaps twice as large.

market for part of the output, the larger proportion of his products being retailed through independent stores.

Manufacturer-Retailer-Consumer Channel. The great bulk of commodities for personal consumption are purchased from retail dealers. Thus the immediate selling problem of most manufacturers is to induce desirable dealers to buy their products. This is often true even when the manufacturer's actual sales are made to wholesalers, for wholesalers will seldom buy unless there is a retail demand, and retailers in turn usually buy only in response to consumer demand.

In selling to the retailer, the manufacturer has the choice of selling to him directly or of utilizing some of the market intermediaries that act as middlemen between manufacturer and retailer. When he elects to sell directly, he uses what is commonly called the manufacturer-retailer-consumer channel of distribution. Although the manufacturer may endeavor to create a consumer demand for his product through salesmen, advertising, demonstration, and sampling, the actual sale is made to the retailer who performs the functions involved in marketing from his store to the consumer. Automobiles,[11] shoes, and men's and women's clothing are familiar examples of products often sold in this manner. Some producers of food products and household goods also sell directly to retailers. Many products are sold directly to large retail organizations—supermarkets, chain stores, department stores, large specialty stores, cooperative retail buying groups, and mail order houses—by manufacturers who use other methods for selling to smaller retail outlets.

Manufacturer-Wholesaler-Retailer-Consumer Channel. The addition of a second middleman, the wholesaler, who buys from the manufacturer and sells to the retailer, forms what is known as the manufacturer-wholesaler-retailer-consumer channel of distribution. This method of sale is often called the "orthodox," "regular," or "normal" channel of distribution and is generally used in marketing such staples as groceries, hardware, drugs, and dry goods to small and medium-sized retailers. The manufacturer using this system in unmodified form would consider his marketing task completed upon the sale of the product to the wholesaler. However, the control and interest of the manufacturer in the marketing of his product does not end at this point. Modern marketing requires the manufacturer to study intensively the consumer and the market and to assist wholesalers and retailers in their performance of the marketing functions. More and more, manufacturers are providing guidance to wholesalers and retailers in their marketing efforts.

[11] At one time, wholesale distributors were of considerable importance in the distribution channel for automobiles, but they have now largely been eliminated. See Charles N. Davisson in Richard M. Clewett (ed.), *Marketing Channels for Manufactured Products* (Homewood, Ill.: Irwin, 1954), p. 84.

Wholesalers too are taking an increasing interest in the operations of their retail customers.

Many manufacturers who sell to wholesalers exert considerable influence upon the sale of their product at each point in the channel of distribution at which a change of ownership takes place. Their efforts begin with the study of the consumer and his needs and desires. Having adapted the product to the requirements of the market, they endeavor to create a consumer demand for it through advertising and other similar devices. These efforts, when properly directed, serve to assist the retailers to make sales to consumers and the wholesalers to sell to retailers. Moreover, both wholesalers and retailers may be encouraged to supplement the efforts of the manufacturer in creating consumer interest. There is thus established a degree of cooperation among the various elements of the channel which, if successful, is of mutual benefit to manufacturer and middleman.

Manufacturer-Agent Middleman-Wholesaler-Retailer-Consumer. A fourth channel of distribution includes an agent middleman who represents the manufacturer. When used in the marketing of consumer goods, such middlemen often take charge of the sale of the manufacturer's product to the wholesaler or retailer.[12] This usually means the addition of another middleman between the manufacturer and the wholesaler or retailer—a middleman, however, who does not own the product but who sells it on a commission basis for the manufacturer. Many textile and grocery products are sold with the assistance of agent middlemen. Wholesalers who merchandise many products sometimes buy through agent middlemen, and importers of manufactured products also utilize their services.

Combination of Channels Is Common. Manufacturers often use more than one channel of distribution. One reason for this is the difference in the markets in which a given manufacturer may be selling. He may be selling in large cities, in small cities, and in rural areas. In the large city he may decide to own his own retail stores, or to sell directly to independent retailers; in smaller cities he may find it more economical to use the "regular" channel of distribution through wholesaler and retailer. Again, in a given city his products may be handled in retail stores which vary greatly in size. He may sell directly to the stores that purchase his goods in large volume, whereas the smaller retailers in the same city may be sold only through wholesalers.

In sparsely settled regions the manutacturer may decide that he can obtain more sales per unit of expense by marketing through wholesalers. In

[12] Most agent middlemen operate as intermediaries between the manufacturer and the merchant wholesaler. In some cases, however, they assist manufacturers in selling to retailers.

more densely populated areas he may do his own wholesaling or even his own retailing. And he may experiment in one market with a new channel while continuing with the traditional methods in the remainder. Different methods are often used in foreign markets from those used at home. A manufacturer who has built up a large volume through dealing directly with the domestic retailer, for example, may find it advisable to utilize wholesale middlemen in a part or all of his foreign trade.

QUESTIONS FOR DISCUSSION

1. Gasoline is used in the text discussion as an example of a convenience good, whereas others have classfiied it as a specialty good (see David J. Luck reference below). Its method of distribution is certainly different from that of cigarettes or groceries, since in most instances only a single brand is carried at a specific retail outlet. Therefore, is gasoline really a convenience good or a specialty good? If a convenience good, how do you explain the differences in its method of distribution?
2. The Committee on Definitions of the American Marketing Association has expressed considerable doubt as to whether there is any validity or usefulness to the distinction between shopping goods and specialty goods; in other words, specialty goods should be included within the shopping goods classification. Richard H. Holton maintains that the test of a specialty good is not the *willingness* of the consumer to make a special purchasing effort but the *necessity* of making it (see the definition in footnote 8) and that specialty goods include both convenience and shopping goods, the outlets for which are relatively few in number so that a special effort to purchase must be made. The discussion in this text gives a still different point of view. What is your conclusion as to the usefulness of the designation of specialty goods? Explain your reasoning.
3. How, if at all, does the need for technical service in connection with a product—as in automobiles, appliances, and the like—affect the consumer's choice of outlet in the original purchase of the product? Is this need for technical service more likely to make these products specialty goods or shopping goods in his mind?

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3. MARKETING INDUSTRIAL GOODS

The distinction customarily made between consumer goods, the subject of the previous chapter, and industrial goods is based upon their use. Consumer goods are those products used by individual consumers and households in final or ultimate consumption, whereas industrial goods are those commodities used in the production of other goods and services or in the operation of a business enterprise or public or private institution. Industrial goods include agricultural raw materials as well as natural raw materials and certain manufactured products, but the discussion in this chapter will be confined to the marketing of manufactured industrial goods and natural raw materials.

MANUFACTURED INDUSTRIAL GOODS

The market for manufactured industrial goods is made up of manufacturers, transportation and storage agencies, public utilities, mining companies, construction firms, wholesale and retail middlemen, governmental agencies, public and private institutions, and service industries. These constitute a large market. The factory value of all manufactured products sold in the United States in 1959 totaled $357 billion.[1] It may be assumed that 45 to 50 per cent of this total output of manufactured goods was sold in the industrial market.[2] Thus the sales of manufactured industrial goods probably ranged between $160 billion and $180 billion, a substantial amount.

Characteristics of the Market

The basic characteristics of industrial goods markets, and those which differentiate them from the markets for consumer goods, can be briefly stated.

[1] *Survey of Current Business*, February 1960, p. 28.

[2] For the reasoning behind the use of these percentages, see Ralph S. Alexander, James S. Cross, and Ross M. Cunningham, *Industrial Marketing* (Homewood, Ill.: Irwin, 1956), p. 4.

The markets for most industrial goods are concentrated geographically; prospective buyers are limited in number; individual purchases are large; technical considerations are important; and demand is derived from, and greatly influenced by, the demand for the consumer goods and services in the production of which particular industrial goods are used. These points will be discussed first, after which other important considerations that influence the marketing of industrial goods will be reviewed.

Geographical Concentration. In contrast to the situation found in the market for consumer goods, most of the buyers of industrial goods are concentrated in a few limited areas. This is true because the largest purchasers of industrial goods are manufacturers, and manufacturing is highly concentrated. Graphic evidence of this is found in the concentration of employment in manufacturing industries in 1954 shown in Figure 3-1. Further evidence of this concentration is shown by the fact that in 1957 there were 49 metropolitan areas in the United States with more than 50,000 manufacturing employees each, and these areas included 57 per cent of all employees compared with about 40 per cent of the nation's population.[3] Furthermore, approximately 1 per cent of the nation's counties, 33 of a total of some 3,100, had 32 per cent of the total number of manufacturing establishments and 39 per cent of all production workers in 1954.[4]

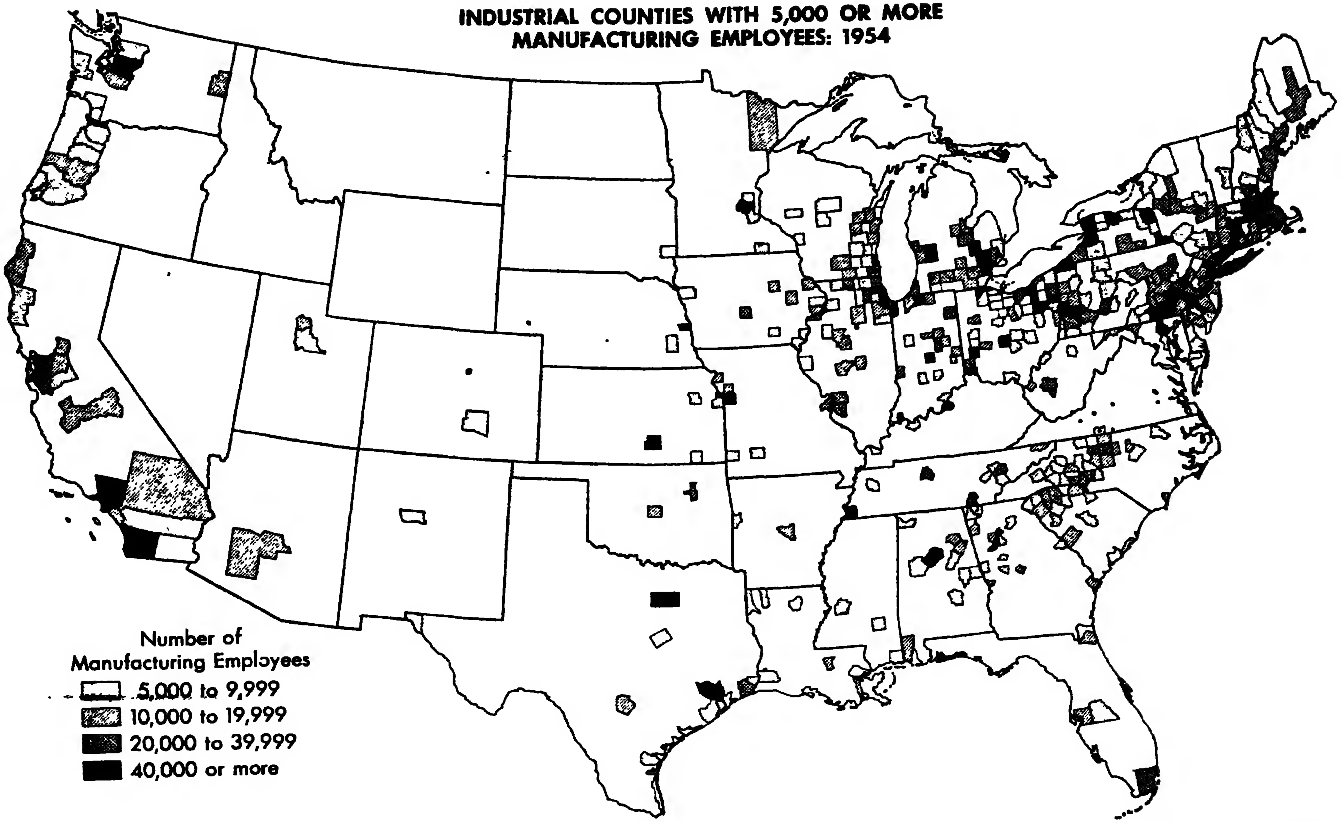
Limited Number of Buyers. It is obvious that the buyers of industrial goods are few in number when compared with the number of purchasers of consumer goods. Including business firms of all types, along with the larger governmental and institutional buyers, there are probably some 5,000,000 buyers of industrial goods.[5] Even though these appear to constitute a large number of buyers, the number indicated is only some 10 per cent of the total number of households in the United States.[6] In addition, there are many industrial products for which the number of purchasers is quite limited. For example, suppliers of railroad equipment have perhaps only a few hundred prospective customers, while automobile tires sold as original equipment for motor vehicles are sold to a very small number of firms. On the other hand, manufacturers of office equipment and supplies have hundreds of thousands

[3] Computed from data in the *Statistical Abstract of the United States: 1959* (Washington, D.C.: U.S. Government Printing Office, 1959), pp. 789–90.

[4] Computed from *U.S. Census of Manufactures: 1954*, Vol. I, *Summary Statistics* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), pp. 60–71.

[5] There are more than 4,500,000 business firms in the United States plus an undetermined number of governmental buyers. See also the discussion of Alexander, Cross, and Cunningham, *op.cit.*, p. 15.

[6] The household is used here to represent the purchasing unit for consumer goods. For information on number of households, see Chap. 5.



Source: U.S. Department of Commerce, Bureau of the Census, Washington.

Figure 3-1. Concentration of Manufacturing Employment in the United States: 1954.

of industrial customers found wherever business and manufacturing are carried on.[7] For these latter firms, the problems of marketing industrial goods may not be greatly different from those involved in distributing consumer goods. But for most producers of industrial goods there are substantial differences.

Large Individual Purchases. The single orders placed by the buyers of industrial goods usually total a considerable amount. Even the smallest purchases are usually large when compared with the level of individual purchases of consumer goods. This fact, combined with the normal situation of few prospects concentrated in limited geographical areas, means that it is often both possible and economical for the manufacturer to direct his sales efforts toward known, individual prospects. It is also an important reason for the prevailing tendency to sell directly to those who use industrial goods. These tendencies are in marked contrast to the mass methods of demand creation and the use of wholesale and retail middlemen which characterize the sale of many consumer goods.

Contrasted with the advantage of selling large orders, however, is the fact that some industrial goods are sold infrequently to particular customers. Machinery and equipment are replaced only when they wear out or become obsolete, and fuel, materials, and supplies are often purchased or contracted for in quantities that will cover the buyer's requirements for a considerable period. This means that the seller of such goods often finds it necessary to keep in touch with customers who will make no purchases over long periods of time, in order to keep his name and products before them and to make certain that his products will be considered when orders materialize. Sales activities of this nature obviously add to the cost of marketing.

Technical Considerations. Because industrial goods are purchased for use in business operations, technical considerations assume great importance. Fabricating materials and parts must be suitable for particular use in making finished products, and machinery and power plants must meet specific requirements. The use of buyers' specifications is common. This often necessitates the development of special products, or the modification of standard products to meet particular needs; and, together with the volume in which many purchases are made, it compels those who sell industrial goods to appeal in the main to the "rational" buying motives of relatively well-informed

[7] In this connection, writers on industrial marketing distinguish between "vertical markets" in which "purchasing is characteristically limited to one industry or a group of related industries"; and "horizontal," in which "purchasing is confined to a common functional group in a number of unrelated industries." The definitions used here are from Robert F. Elder, *Fundamentals of Industrial Marketing* (New York: McGraw-Hill, 1935), p. 10. See also Alexander, Cross, and Cunningham, *op.cit.*, p. 21.

buyers. That is, sales appeals must be made to the business and technical sense of the buyer, rather than through the instinctive and emotional appeals which are sometimes important in selling to final consumers.[8] They must often be accompanied by technical demonstrations of the qualities of a product, or technical advice to show how a product can be adapted to the particular needs of the buyer. Because technical considerations are important and because many of the technical problems faced by purchasers of industrial goods are peculiar to their particular business, sales negotiations tend to be long and expensive. But since the resulting orders are often large, the percentage of expense to sales may be very low.

The technical effort involved in bringing about a sale often makes it necessary for the selling company to have highly trained salesmen, or technically trained men who can be called in to assist the salesmen when they are confronted with difficult problems. In some instances such technical service is needed to assist the buyer to meet definite problems with which he is faced, or to show prospective customers how they can use the products of the selling company to advantage. New labor-saving devices, for example, such as automatic machinery for use in factories, or accounting machines for use in banks and offices, must be brought to the attention of prospective buyers, who must also be convinced of the utility of these products for their own particular purposes.

In addition to the ability to give technical advice to prospective customers before the sale is made, many manufacturers find that service after the sale is also important. This is particularly true in marketing mechanical devices. Repair service and parts must be kept available to meet emergencies. When new equipment is installed or new materials are substituted for old, it is frequently necessary for technical advisers to remain with the buyer or to be available on call until the production personnel are able to carry on without assistance. Many repairs can be made by the user, and parts needing frequent replacement are likely to be kept in stock; but unusual repairs often call for skills not possessed by the using companies, and it is not economical for them to stock parts seldom replaced. Thus, in order to care for the requirements of their customers, as well as to meet competition, many manufacturers find it necessary to conduct extensive servicing operations. Such operations range from making necessary repairs and renewals on call to regular periodical inspections.

[8] See Delbert J. Duncan, "What Motivates Business Buyers," *Harvard Business Review*, Summer 1940, pp. 448–54. It should not be assumed that all buying of industrial goods is completely rational, especially since an objective measurement of "rationality" might be difficult to obtain. For example, reciprocity in buying is not uncommon among industrial firms but its rationality is often questioned. For a brief discussion of reciprocity, see Chap. 19.

These technical services, both before and after sale, often raise difficult problems for the selling companies. Adequate service is usually expensive, both in men and inventories. Presale technical service is commonly given free and is looked upon as a part of the selling operation. But the information developed by this service can often be used by the prospective purchaser whether he buys the selling company's product, buys from a competitor, or decides to make the product himself. Sometimes the seller is able to charge a fee for this service, but more frequently he must render it without compensation. He may be able to keep the expense from becoming excessive by advising only prospects who will, in his opinion, develop into profitable customers, always with the objective of making sales to enough prospects to cover the total service expense. The customer usually pays for services rendered after he buys the product. Sometimes such payments are large enough to provide a net profit on the work done or the parts supplied; sometimes they meet only part of the expense. But regardless of how the expense is met, the service performed and the charges therefor are often important considerations in the successful marketing of industrial goods.

Derived Demand for Industrial Goods. Industrial goods are used chiefly in the manufacture of consumer goods or other industrial goods. Thus the demand for them is dependent on the demand for other products and ultimately on the demand for consumer goods and services. If the demand for the finished product of the industrial goods buyer is seasonal, the demand for the fabricating materials and parts used in manufacturing tends likewise to be seasonal. If the demand for the finished product rises and falls with cyclical changes in general business conditions, so does the demand for the fabricating materials and parts used in its production. Thus the demand for the products of many textile mills is seasonal because the sale of clothing is seasonal; and the many establishments making parts used in the manufacture of automobiles find that demand is not only seasonal but is also subject to the cyclical fluctuations of the automobile industry.

This relationship varies considerably, however. The demand for fabricating materials and parts and for supplies tends to vary closely with the anticipated demand for the finished product—"anticipated demand" because such products must usually be ordered some time in advance of the actual production of the finished products. The demand for equipment, on the other hand, varies much less closely with the demand for the finished goods. When increased business is anticipated, manufacturers tend to enlarge plant and equipment in order to take advantage of this demand. But when consumer demand falls off, sales of such basic equipment are subject to a drastic decline. Plants and basic equipment are durable goods which can be used for long

periods of time, periods which obviously lengthen when use decreases. Consequently, when demand falls off, factories can produce more goods with existing equipment than they can sell at a profit. There is no need to purchase more until the former production level is reached or the equipment wears out or becomes obsolete. In such times, it is unusual to make purchases of equipment or additions to plant which cannot show immediate results in the reduction of expenses or in improved products which will help to strengthen the manufacturers' competitive position.

The close relationship that so frequently exists between the demand for industrial goods and the demand for the products of those who purchase them has important repercussions on pricing policies. It is obvious that price is an important consideration because buyers of most industrial goods must of necessity control their expenses in order to compete effectively. This is particularly true of the purchase of fabricating materials and parts when they make up a large part of the direct costs of finished products. The amortization of the costs of equipment and the expense for the supplies used in their operation are also important items of expense. On the other hand, the demand for industrial goods is largely dependent on the demand for the finished product. Thus it follows that price reductions do not increase sales when purchasers' sales have declined. Reduced prices under these conditions will result in increased sales only when they make it possible to reduce the costs of the purchasers' products to such a point that the latter, in turn, can reduce prices or improve the salability of their products. This is often impossible. Even industrial goods that become a part of the finished product, and thus constitute a part of direct costs, may account for only a small part of the cost of the finished product. The share of the cost of very expensive machinery which must be borne by a single unit of production may be almost infinitesimal. In such cases drastic price reductions may have little or no effect on the sale of the final product, although they may result in slightly increased profits to the buyer. But since the demand for industrial goods is so largely dependent on the demand for consumer products, a price cut by one firm is likely to bring on price cuts by all of its competitors, resulting frequently in selling approximately the same volume of goods but at lower prices.

Some firms selling to the industrial goods market attempt to increase their own sales by helping to increase the sales of their customers. Steel and aluminum producers, for example, as well as other manufacturers of fabricating parts and materials, advertise in consumer media, sometimes mentioning the specific manufacturers who use their products. The chief purpose of such consumer advertising is to develop consumer good will which

will increase the sale of the customers' products and thus increase their purchases of the advertisers' products.

Classes of Industrial Goods

Industrial goods may be divided into four general classes: fabricating materials and parts, equipment, supplies, and raw materials. The first three, which constitute the classes of manufactured industrial goods, will be discussed at this point.

Fabricating Materials and Parts. Included in this group are those industrial goods which have been processed but which are not ready for use by ultimate consumers until they have been further processed or combined with other materials or parts to make a finished product. The distinction between materials and parts is not precise. Fabricating materials undergo further processing and are changed or combined with other products so that they lose their identity as individual products, while fabricating parts are incorporated without change into the finished product. Examples of the former are fabrics used in making automobile tires and tubes, metal sheets, bars, lumber, and chemicals. Representatives of the latter are electric motors and batteries, automobile bodies, wheels, tires, and steel bearings.

The buyer of fabricating materials and parts requires uniform products of particular qualities. He must buy at prices which enable him to produce and sell the finished item on a competitive basis. He must also be assured of an adequate supply as needed. As a rule, the buyer also has definite ideas of what he wants. Purchases consequently are made on the basis of specification or sample, and the delivered products are often inspected and analyzed to determine whether they conform to the specifications.

Since successful procurement is essential to production and since the cost of fabricating materials and parts often makes up a major part of total costs, it is common practice to purchase such products under contracts covering a period of time, often a year or more. Many manufacturers who require fabricating materials and parts even find it advantageous to make such products for their own use, or to control or have close business relationships with those who supply them. Consequently, the integration of such manufacturers with their sources of supply is frequent.

The methods used in marketing fabricating materials and parts are relatively simple. Negotiations are frequently carried on between direct representatives of the buyer and seller, and since purchases usually are made in large amounts direct purchase is feasible. Moreover, the importance of quality and dependability of supply often results in continuous business relationships

without continued sales effort, once the buyer is satisfied with his source of supply.

Although the bulk of such products are marketed directly, middlemen have a place. Merchant middlemen often sell to buyers who regularly purchase in small volume as well as to large buyers needing emergency supplies on short notice, and agent middlemen may operate between sellers and buyers. The operations of middlemen are greatly facilitated when the products handled are standardized within the trade, as is the case with some of the more common products of steel mills.

Finally, it should be pointed out that many of these products are sold both to industrial goods buyers and in the consumer goods market. This is true, for example, of automobile tires and parts, paint, certain types of tools, and other products. The marketing problems involved in serving the two markets are usually very different. Channels of distribution are different, pricing policies are likely to differ, and demand-creational methods that are emphasized in the consumer market may not be used at all in the industrial market. Accordingly, many manufacturers specialize their marketing personnel by type of market and virtually maintain separate organizations for the two markets.

Equipment. The term "equipment" includes a wide range of products. On the one hand, there are the basic power and mechanical installations which are frequently produced to order and designed to meet the particular needs of an individual buyer. On the other hand, there are many items which as a rule are not specially constructed to meet individual needs: factory accessory equipment such as tools, small motors, and portable drills, and office equipment such as desks, chairs, typewriters, and calculators.

Equipment has some of the characteristics of semimanufactured goods and some of those of finished products for personal consumption. As with semimanufactured goods, measurable physical characteristics are often important; and to the extent that these are controlling requirements, demand creation is of minor and price of major importance. But the mere physical characteristics of such products are often less important than their performance in use or their suitability for a particular purpose. When this is true it is frequently difficult to test them with any great degree of accuracy, except as they are tested out in operation over a period of time. Future performance is hard to determine in advance, and opinions may well differ on the importance of particular features and on the manner in which the equipment of competing manufacturers will perform. These conditions leave room for sales effort.

The possibility of rapid obsolescence, owing to improvements, presents

a difficult problem, particularly in industries in which processes are changing rapidly. The recent advances in automation illustrate the general situation. A manufacturer considering the purchase of new equipment is well aware of the probability that within a relatively short time a new and improved item will be available. He must then make a decision of whether to buy immediately or postpone the purchase. If he buys immediately, he must consider whether to purchase an expensive item of high quality or a less expensive product which may still probably outlast the purchaser's need for it. Furthermore, machines may be built to utilize varying degrees of labor in the performance of the same mechanical operation. The prospective purchaser, therefore, must consider the present efficiency of his plant, present and prospective wage rates, and the general efficiency of his labor force. These factors must be compared with the cost of the new machine and the probable gain in production efficiency that will result from using it. Here, certainly, is a wide opportunity for convincing sales effort on the part of suppliers, sales effort that will really assist the purchaser to solve his buying problem.

Office furniture and equipment present still different problems. In fact, they have many of the characteristics of consumer goods. Styles and materials vary greatly, as does the type of construction. Many such products are sold on a basis of personal preference and are subject to the same types of sales appeals as are used for consumer goods. They often resemble consumer goods in other ways. They may be purchased only occasionally or in small quantities, the buyers may not be skilled, and adequate care or enough time may not be used in an effort to obtain the lowest price for a particular quality as would be done with larger or more frequent purchases. Moreover, new and improved products, for which a general demand must be created, are constantly appearing. It may require extensive sales effort, for example, to induce business executives to install punched card equipment, electric calculators, or electric typewriters.

Supplies. Supplies consist of such products as fuel, lubricants, stationery, and office supplies. They are used up in the operations of the plant or office, but they do not become a part of the finished product. If they involve large expenditures, as does fuel, or if they are important to the successful operation of the plant, as are lubricants, their purchase has the same characteristics as the purchase of other important industrial goods—direct purchase on specification or by sample, with the usual requirements of a uniform and adequate supply at a low price, and with little opportunity for demand creation on the part of the seller. Purchases under these conditions are likely to be supervised by a higher official and may be made only after trial or consultation with experts. Once a decision has been made, further purchases may be

routine, sometimes as a part of a contract covering a considerable period of time. The general run of purchases of supplies, however, is more or less routine and may or may not be made after careful technical consideration or test. The possibilities for demand creation in the sale of supplies vary widely, depending in part on the amount of money involved and in part on the possibility of making accurate tests of the products.

Channels of Distribution

The principal channels of distribution for manufactured industrial goods are:

1. Manufacturer to industrial user.
2. Manufacturer to merchant wholesaler to industrial user.
3. Manufacturer, with the assistance of an agent middleman, to industrial user.
4. Manufacturer, with the assistance of an agent middleman, to merchant wholesaler to industrial user.

Predominance of Direct Sale. Although wholesale middlemen, both merchant and agent, are used in the marketing of industrial goods, a large percentage of total sales are made directly either from the factory and sales headquarters or through the manufacturers' own sales branches.[9] This is in marked contrast with consumer goods, many of which are sold through wholesale middlemen and nearly all of which are sold to final consumers through retail middlemen. Basic reasons for this tendency to sell industrial goods directly arise from considerations which have already been discussed and may be briefly summarized as follows: because such goods generally are sold in large volume to a relatively small number of purchasers located in concentrated areas, direct selling can be economically carried on; and because technical considerations and price are important, direct selling often is desirable. Even small firms usually obtain those goods they buy in large volume directly from the producers or through agent middlemen.

[9] Estimates of the amounts sold directly range from 60 to 80 per cent of all manufactured industrial goods, but it does not seem possible to arrive at an authoritative figure. One reason appears to be that there is some confusion as to the meaning of "direct sale." Although agent middlemen are sometimes used to bring buyer and seller together, such transactions are usually considered by the trade to be direct sales. Another reason is that the percentage of output sold directly varies greatly according to the product. For example, it is stated that "over 80 per cent of all steel tonnage is sold directly," but the percentage varies from nearly 100 for rails, semifinished products, and tin plate to 24 for oil country pipe to only 2 for woven wire fence. See Bay E. Estes in Richard M. Clewett (ed.), *Marketing Channels for Manufactured Products* (Homewood, Ill.: Irwin, 1954), pp. 308–9.

Large buyers of both consumer goods and industrial goods prefer to buy directly in the hope of obtaining lower prices and better service. But a further reason for direct purchase of industrial goods arises from the belief that it enables the buyer to keep in closer touch with new developments; and when particular problems call for technical advice from sources of supply, or for the development of special products, direct contact is likely to prove more satisfactory.

Notwithstanding the fact that large quantities of manufactured goods are sold directly to users, it is quite probable that a greater number of *individual orders* for such goods are handled through middlemen. This arises from the fact that, while many buyers deal directly in the purchase of products they use in large volume or which are of great value or of great technical importance, they purchase from middlemen many other products used in small quantities. Furthermore, the great majority of all purchasers of industrial goods are small and medium-sized establishments, and most of their orders are too small to warrant direct purchase.

Manufacturers of industrial goods, perhaps more than manufacturers of consumer goods, often use both direct and indirect methods of marketing. They may sell directly in the areas where customers are highly concentrated and depend on middlemen to sell prospects in other areas. They may handle carlot purchases directly and leave the less-than-carlot business for middlemen. They may sell directly to firms buying their products in large volume, and leave smaller buyers for middlemen to supply. Thus there is a definite place in the marketing of industrial goods for wholesale middlemen who handle small orders and emergency orders, but the bulk of the volume is marketed directly from manufacturer to user.

NATURAL RAW MATERIALS

Raw materials constitute the fourth class of industrial goods and may be divided into two general subclasses: natural raw materials and agricultural raw materials. The former are products of the forest, mine, and sea and the latter are products of the farm, which undergo manufacturing processes before they are ready for use. The marketing of natural raw materials will be discussed in the present chapter, since the marketing methods used are not unlike those previously described for manufactured industrial goods. The characteristics of the two types of products are substantially different, however, and this fact does result in certain differences in the marketing problems involved.

Characteristics of Raw Materials

Supply Characteristics. Perhaps the most significant characteristic of natural raw materials is that the supply of most such materials is limited and for some it is nonreproducible. For products of the sea the supply is reproducible though limited. Forest products, although somewhat limited in supply at any given time, are reproduced over a period of many years through reforestation programs. But for many natural raw materials, especially minerals, there is a nonreproducible supply. Additional supplies can be obtained only through the continual search for previously undiscovered sources or through efforts to make previously submarginal supplies economically recoverable. Thus the total supply is limited, although the exact limits for many products are still unknown.

Because of this limited known supply, there is a tendency for processors and manufacturers to attempt to gain control of the sources of supply and to integrate their operations in such a way as to assure themselves of a definite supply of necessary materials. This point will be discussed at greater length later in the chapter, but it is obvious that this tendency to control supply sources results in a relatively short channel of distribution. Middlemen are not needed to effect transfers in ownership when the raw material is owned by the same firm that processes it. To the extent, however, that sources of raw materials are still owned by independent firms, and particularly when the size of purchase and sale is small, middlemen may be needed to assist in the marketing of these materials. Nevertheless, many manufacturers still prefer to seek out their own sources of supply and buy directly from producers.

Production Characteristics. Although the production of natural raw materials is not subject to as close control as is the production of manufactured industrial goods, the conditions under which these two classes of commodities are produced are relatively similar—much more so in fact than are the conditions of production for natural as compared with agricultural raw materials. Agricultural production is widely scattered and seasonal, characteristics that do not hold true to the same extent for natural raw materials. Although there are seasonal aspects to the production and transportation of some natural raw materials,[10] many can be produced throughout the year. Production of some natural materials is somewhat scattered, as in the case of coal, but the production of others is reasonably well concentrated. In addition, the number of producers of natural raw materials tends to be significantly fewer

[10] For example, commercial fishing is a seasonal occupation; many logging operations shut down during the winter; and iron ore cannot be transported by way of the Great Lakes during the winter months.

than in the case of agricultural products. The reasons for this lie partly in the fact that the production of natural raw materials may be a somewhat specialized type of occupation, often requiring special skills and capital equipment, and partly in the tendency of manufacturers, as previously described, to attempt to control sources of supply.

Thus the problems of marketing natural materials tend to be more like those involved in the marketing of manufactured industrial goods than they are like those with which agricultural producers are concerned. Production often can be controlled to coincide closely with demand, peak-load storage and transportation facilities may not be required, and marketing can be carried on effectively without the use of varied types of middlemen. In brief, the concentration process for natural raw materials may be of less importance than it is for agricultural materials. And yet, there are many small producers involved in the production of some natural materials; and for these producers, it is often necessary to have middlemen to carry on the process of concentrating their products.

Product Characteristics. The product characteristics of natural raw materials, however, are quite similar to those for agricultural raw materials and unlike those for manufactured industrial goods. Quality is variable and cannot be controlled. Thus there is a need for grading and close inspection of the quality of the product. Some products, such as those of the sea, are perishable, although others, particularly those of the mines, are not. Above all, raw materials are bulky. This is perhaps the most important product characteristic of raw materials from the marketing standpoint. Transportation costs are large in relation to the value of the products. Water transportation, which is usually more economical than shipping by rail, is used whenever possible. In the case of petroleum, when water transportation is not feasible, pipelines are used both for the raw material and to some extent for the finished products in order to reduce transport costs. The bulkiness of raw materials also makes them expensive to store and encourages, insofar as possible, a close adjustment of production to demand.

Problems of Marketing Raw Materials

It is evident from the foregoing discussion that the marketing system for natural raw materials is not unlike that for manufactured industrial goods. The channels of distribution and the middlemen involved are similar. There is a substantial use of agent middlemen to assist in effecting transactions between seller and buyer, some use of merchant middlemen—especially drop

shippers [11] in the cases of coal and lumber—and a considerable use of direct selling methods. There are, however, certain problems involved in the marketing of natural materials which differ at least in degree from the problems found in marketing manufactured goods.

Raw materials are commonly used in large quantities in individual manufacturing plants, but the sources of supply are often located at a great distance from manufacturing centers. Thus the cost of transporting the bulky materials may be substantial. Moreover, as a rule, manufacturers require materials which conform to specific standards, and they desire assurance that an adequate supply will be available as needed. But raw materials are extracted from nature and the quality of the product is likely to be quite variable. Thus the materials available on the market at any given time may not meet the needs of particular manufacturers, and even when they do they may not be available in sufficient supply. Accordingly, there are three problems of raw materials marketing that warrant specific discussion at this time: (1) transportation cost and its effect upon the location of processing facilities, (2) the standardization of supplies to meet the particular needs of specific manufacturers, and (3) the development of methods which give reasonable assurance of obtaining an adequate supply.

The Cost of Transportation. In the marketing of raw materials, transportation is a particularly important function and transportation costs are significant because of the bulkiness of the products. These costs usually determine whether the materials will move to the factory in their crude state or whether there shall be at least a degree of processing at the source. The location of factories at a considerable distance from the source of their raw materials is a common phenomenon. But, in the case of very bulky products, of products in which there is a large percentage of waste or which are highly perishable, and of products extracted on a large scale, partial or even complete processing may take place before the product is moved very far toward the place of its ultimate consumption.

Lumber mills, for example, are usually located at the forests, although the furniture and houses made from lumber are manufactured and constructed in distant centers of manufacture and population. This is the case because the market for lumber is definitely limited by the cost of its transportation, and there is a certain amount of waste involved in hauling logs for great distances. Ores are often partially refined near the mines. This is particularly true when a long expensive rail haul is involved. The reduction of iron ore to metal, for example, is frequently undertaken where the ore and other

[11] A drop shipper is a wholesaler who takes title to the product but not possession of it. See discussion in Chap. 16.

raw materials—fuel and flux—are found. The pig iron is easily shipped in bulk and is of sufficient value to warrant a long haul, whereas it may prove too expensive to haul the ore, the fuel, and the flux for similar distances.

Where raw materials and finished products are both bulky, in relation to value, as is the case in the cement, brick, and tile industries, there is a tendency for the industry to be operated on a local basis.[12] When there is a suitable supply of such raw materials at hand, a local plant can undersell more distant producers even though the latter may be larger. When the raw material is perishable, there is likewise a tendency to manufacture near the source of supply. For example, salmon canneries are located in the Pacific Northwest because the cost of transporting the refrigerated raw product would be greater than the cost of shipping canned salmon.

The Importance of Standardization. The second major problem in marketing raw materials arises out of the necessity of providing standardized materials to meet the requirements of manufacturers. Manufacturers prefer to use and frequently must use standardized raw materials of the exact quality needed to produce their finished product. But individual producers and even whole producing areas cannot always meet this essential requirement. Many raw materials are not of uniform quality when they are produced. Furthermore, the quality of materials required by individual manufacturers often varies from time to time and from finished product to finished product. Raw materials, unlike manufactured goods, must be taken as nature supplies them, and the producer is seldom able to avoid variations in quality.

The stress placed upon standardized raw materials by manufacturers has been responsible for many efforts to establish standards and to improve grading by producers, middlemen, and government agencies. The considerations mentioned give to well-graded products a value in excess of those which are not graded. In some instances premiums are paid for graded products which appear to be higher than the advantages of standardization seem to warrant. But such premiums furnish an incentive to the producer of raw materials and to the middlemen who market them to grade carefully in order to profit by the higher price. Sellers of raw materials, moreover, are coming to realize that grading improves their bargaining position by placing materials upon an established basis.[13] Thus most industrial raw materials are sold by grade and specification, and all materials are carefully inspected by the purchaser to be certain that they meet his requirements.

[12] A. Hamilton Chute, *Marketing Burned-Clay Products* (Columbus: The Ohio State University Press, 1939), pp. 3–21.

[13] Governmental assistance is often available to small producers for this purpose. See, for example, *Measuring and Marketing Farm Timber*, Farmers' Bull. No. 1210, rev. ed. (Washington, D.C.: U.S. Department of Agriculture, 1958).

The Need for an Assured Supply. In addition to his insistence upon procuring particular qualities of raw materials, the manufacturer desires to make sure that an adequate supply will be available when it is needed. Modern manufacturing involves such large fixed investments, and the maintenance of a skilled labor force depends so much on regular and permanent employment, that business executives endeavor to operate their plants continuously. Even when the consumption and sale of the manufactured product is seasonal, production and cost conditions usually make it imperative that the factory operate at a uniform rate throughout the year if that is possible. Of even greater importance to the manufacturer is the necessity of having his finished products available to the consumer at the times when they are wanted.

The manufacturer's need for an assured supply of raw materials is perhaps little different from his need for an assured supply of fabricated parts, but he probably has more alternatives available by which the supply of materials can be obtained. As mentioned previously, the purchaser of fabricated parts is likely to enter into a contract with one or more suppliers for a period of a year or longer. The terms of such contracts are quite variable, but essentially they assure the purchaser of a definite supply of parts as needed usually at a price that is more or less fixed over a period of time. In a similar fashion, the purchaser of raw materials may contract with suppliers for future delivery, although the price established is likely to be more flexible and to depend upon current market conditions at the time of delivery.

Actually, it is this problem of fluctuating prices for raw materials which causes purchasers to place less reliance on long-term contracts and more on open-market purchases. The price at which materials are obtained is usually an important factor in determining the profitability of the manufacturer's operation. Accordingly, many manufacturers prefer to purchase them on the open market as needed, or in advance of need.[14] In this way, they can study price trends and in many instances are able to make purchases at more favorable prices than might be possible under long-term contracts. All in all, a considerable amount of raw materials is purchased on the open market, often through middlemen. But the purchaser has less assurance of obtaining needed supplies when this policy is followed than is the case when long-term contracts are used.

Manufacturers who have the required capital and who find other methods unsatisfactory may assure themselves of raw materials by establishing control over important sources of supply. This, of course, is merely vertical integration

[14] The relative merits of forward buying compared with buying for current needs are discussed in Chap. 19.

and is a device often used by large firms to assure themselves of supplies of fabricated parts as well as raw materials. With respect to the latter, it is most likely to be used when the supply is especially limited or is so located that it can easily be brought under the control of a few owners. In this way, the manufacturer protects his position and assures himself of needed materials. In some instances, manufacturers establish their own sources of supply in order to avoid the risks of fluctuating market prices. As previously mentioned, the prices of most raw materials do fluctuate over a wide range as demand and supply conditions change. The manufacturer who possesses his own supply sources is assured of a more stable price situation and need not maintain a large force of expert purchasing personnel to follow market prices closely. Finally, some manufacturers obtain sources of supply in order to achieve economies of integration, in marketing or production or both.

The ownership of clay beds by brick and tile plants, the ownership and leasing of ore lands and coal mines by large steel corporations, and the ownership and operation of crude-oil producing facilities by the large integrated oil companies are all examples in point. To cite a specific case, the United States Steel Corporation and its subsidiaries own and operate iron ore mines in Minnesota, Michigan, Wisconsin, Alabama, and Utah in the United States, in the province of Quebec in Canada, and in Venezuela; manganese ore property is owned in Brazil and zinc properties in Tennessee; coal mines are owned or operated under lease in ten states ranging from the Appalachian fields to Colorado and Utah; limestone and dolomite mines are operated in a number of states; in addition, the company controls deposits of cement rock, shale, clay, gypsum, and fluorspar.

When a source of supply is owned or leased there is, for all practical purposes, no marketing. Title to the goods is already transferred or, in the case of leasing, already arranged for. Sometimes only the physical problems of moving the goods remain. There is, however, considerable difference of practice among firms. In some cases no "selling" of any kind is involved. In others, the supplying part of the organization may be an incorporated subsidiary carrying on business quite independently and selling at the going market price wherever sales can be made, whereas the purchasing organization of the parent company may buy wherever the best product and prices can be obtained. It is sometimes assumed that the ownership of sources of supply gives an advantage because supplies can be purchased at "cost." But it is evident that a successful company must make a profit on its investment in sources of supply, and it appears to be rather common to make interplant sales at the market price. If such sales are made at cost, then a higher rate of profit must be made on the sale of finished products.

Conclusions. It is evident that manufacturers using similar raw materials do not all use the same methods of assuring themselves of adequate supplies. Financial resources, volume of purchases, location, and changing conditions in the industry may all bear on the selection of methods. Neither does the individual manufacturer usually confine his procurement procedure to any one method. Purchase on the open market as the need arises is the preferred method, involving small investment in supplies and few risks from deterioration or price changes. But as the possibility of obtaining supplies on demand at reasonable prices grows less likely, purchasers turn to the other methods which offer greater security.

CASE PROBLEM—BEHR-MANNING COMPANY *

The Behr-Manning Company of Troy, New York, is a manufacturer of industrial tapes and abrasives. Although virtually unknown to the consumer market, the company has the reputation among industrial buyers for producing high quality paper and cloth tapes for industrial use. The company's product development department has recently designed a new pressure sensitive cellophane tape, and the company is faced with the problem of whether to manufacture and sell this new product to the consumer market.

The Behr-Manning Company is an old established firm, conservatively managed and publicity shy. The present company was formed in 1928 with the merger of two sandpaper manufacturers—the Behr Company, originally started in 1872, and the Manning Company, founded in 1912. In 1930 the merged company became a wholly owned subsidiary of the Norton Company, one of the world's largest manufacturers of grinding wheels and abrasive grain and grinding machinery.

Under the influence and direction of the Norton Company, Behr-Manning has become one of the large producers of industrial tapes and abrasive sanding materials. Its products are sold under the brand name "Behr-Cat" directly to industrial users and through industrial wholesalers. Its trademark is a black and white picture of a standing bear enclosed in a triangle. Its packaging is also drab and without much color.

The company maintains a national sales organization and operates 16 warehouses throughout the nation. It advertises in business publications. All in all, it employs about 500 persons in its marketing organization to handle these various aspects of selling, advertising, and physical distribution. The company's experience in consumer markets is quite limited, although it does sell "Behr-Cat" tapes and abrasive sanding materials in relatively small amounts through retail paint, hardware, and do-it-yourself suppliers.

The new cellophane tape developed by the company does not represent a radical departure from its present line of products. Existing manufacturing techniques used by the firm in processing and coating its industrial tapes can also be used for the new product. The new tape is believed by the product development de-

* Adapted from an article in *Business Week,* October 12, 1957, pp. 120 ff.

partment to be a quality tape, equal to or better than the products already available in the market.

The total market for cellophane tapes is believed to amount to about $70 million per year. These tapes have industrial uses, but the larger part of the market consists of products sold to the ultimate consumer. The leading producer of cellophane tapes at present is the Minnesota Mining and Manufacturing Company whose Scotch brand tape is very well known. The Minnesota Company's domination of the field has resulted from (1) a monopoly situation due to patents that have recently expired, and (2) the aggressive promotional program of the company. If the Behr-Manning Company enters the cellophane tape field, it will also face competition from another producer, the Permacel Tape Corporation whose brand name is Texcel.

What are the favorable factors and advantages of manufacturing and marketing the new cellophane tape? What are the unfavorable factors and disadvantages? Indicate the marketing problems that the company will encounter in the consumer market and how they differ from those which it has experienced in the industrial market. What do you think the company's decision should be and why?

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4. MARKETING AGRICULTURAL PRODUCTS

There are two broad classes of agricultural products: consumer goods and raw materials. It is evident that some agricultural products are used by final consumers in the form in which they leave the farm. Most of them, however, are raw materials for use in manufacture. Some are used in both ways. Fruits and vegetables consumed in their natural state are consumer goods; when they are used by the canning factory, they are raw materials. Eggs used for home consumption are also consumer goods. Milk may be a consumer good, but to a large extent it undergoes some degree of processing before it reaches final consumers. When this is the case it may be classed as a raw material, along with livestock, the grains, cotton, and wool. Existence of these two classes of agricultural products—raw materials and consumer goods—makes it necessary to keep clearly in mind that the marketing of many farm products involves a process for placing them in the hands of manufacturers, and that from this point on their marketing is a problem of the manufactured goods market. Products of this nature must be distinguished from those agricultural food products for which marketing involves transferring them to consumers in approximately their original form.

CHARACTERISTICS OF AGRICULTURE

The marketing of agricultural products tends to be a rather complex process, especially in comparison with the marketing process for manufactured goods and natural raw materials. Because of the greater importance of the concentration process, the channel of distribution is likely to be longer and to involve a greater number of middlemen. Transportation and storage facilities must be provided in sufficient quantity to handle peak seasonal loads

even though these facilities will not be utilized during a considerable portion of the year. Financing must also be available on a seasonal basis. Agricultural products usually must be standardized and graded, and special transportation and storage facilities sometimes are necessary to prevent deterioration of the product prior to the time of consumption. The reasons for this more complex marketing process lie in the characteristics of agriculture and of the production and consumption of agricultural products.

Production Characteristics

Small-Scale Production. Although the average size of farms has been increasing steadily for several decades, agriculture is still essentially a small-scale industry—in contrast with the prevailing situation in manufacturing.[1] About three fourths of the total commercial output of agricultural products comes from farms which are operated as a family unit.[2] The farmer's chief business is to produce, and he frequently has neither the time, the ability, nor the knowledge to market effectively. Moreover, marketing operations—selling, grading, storing, for example—must be carried out on a large scale to be performed effectively and economically. These conditions handicap the individual grower in his marketing efforts, and largely account for the development of middlemen and cooperative associations in the marketing of farm products.

The individual grower is seldom able to influence the demand for his product. It is generally not worthwhile for him to engage in specialized sales or advertising activities designed to create demand. His resources are too limited and his production too small to warrant the effort. In addition, many agricultural products do not lend themselves readily to this type of activity. Brand names are not easily affixed to the products, and the quality of one producer's output is not readily distinguishable from that of another. Because of these difficulties, most of the efforts to create demand for agricultural products—unlike the efforts for manufactured goods—are carried on by independent middlemen, by cooperative associations such as Sunkist Growers, Inc., and the Diamond Walnut Growers, or by state agencies such as the Washington State Apple Commission.[3]

[1] There were approximately 4,750,000 farms in the United States in 1958 with cash receipts for the year of some $34 billion. By comparison, there were only 325,000 manufacturing enterprises but their sales volume amounted to more than $300 billion.

[2] Richard L. Kohls, *Marketing of Agricultural Products,* 2nd ed. (New York: Macmillan, 1961), p. 52.

[3] There can be little doubt regarding the effectiveness of the efforts of an organization such as Sunkist which combines aggressive advertising, its own sales agencies, and control over the marketing of the product. There is, however, some question as to how effective is a

Scattered and Specialized Production. Agricultural production is carried on by scattered producers wherever the land and climate are suitable for production, and thus in areas that are determined with little consideration for their proximity to markets. Furthermore, because of peculiarities in soil or climate, the farms in particular sections tend to become specialized in the growing of similar products, so that we have specialized agricultural areas as well as specialized farms. But the densely populated metropolitan areas and the large factories in which the bulk of agricultural products is consumed require a large volume and a wide variety of products, which must be supplied regardless of their place of production.

Because producers are located at a considerable distance from consuming centers and because each farmer produces a relatively small amount of product, it is necessary to provide a marketing system that will concentrate small quantities of agricultural products into larger lots for shipment to processing and consuming centers. Thus fresh fruits and vegetables are gathered together at local shipping points and shipped to the large city markets for dispersion to final consumers. Wheat and cotton are concentrated in much the same way in local markets and then, in most instances, are concentrated further at the large central, or terminal, markets from which the products are dispersed to mills and factories. In order to meet the needs of the population for food and in order to supply manufacturing plants with raw materials, it is necessary to concentrate agricultural products where they are easily available for consumption or for processing by manufacturing plants. Although there has been some tendency in recent years to bypass the central markets, the distinguishing feature of the marketing system for agricultural products, as compared with that for most manufactured goods, is the necessity for performing the concentration process.

Seasonal Production. The seasonal production of agricultural products increases the difficulty of marketing them and adds to the work involved in the equalization process. Most farm crops mature during a relatively short period of the year. Because of this there usually occurs a "peak load" in their sale, storage, transportation, and financing. Consumption, however, takes place more or less uniformly throughout the year, at least for that majority of products that are capable of being stored for a few months or longer. Thus

state or industry program which devotes its efforts primarily to advertising without establishing control over the general marketing and sales program. See discussions by Sidney Hoos, Frederick V. Waugh, and others on "Commodity Advertising of Farm Products," *Journal of Farm Economics*, May 1959, pp. 349–88; also R. D. Tousley, "Advertising Fresh Fruits and Vegetables," *Harvard Business Review*, Summer 1944, pp. 447–58 and Autumn 1944, pp. 79–94.

a large part of the annual wheat crop is normally marketed by farmers in July and the three following months, but flour mills operate more or less uniformly throughout the year. Similarly, the bulk of the cotton crop is marketed in the four months from September through December, whereas domestic mill consumption per month runs approximately 7 to 9 per cent of the annual total. Accordingly, there must be storage facilities sufficient to care for the entire crop, facilities that will be fully utilized only for a short period of time after harvest. In the same way transportation agencies have a peak-load problem, since there are heavy shipments of many products to central markets immediately following harvest time. All of this increases the expense of marketing and provides problems that are not generally found in the case of manufactured products.

Product Characteristics

Variation in Quantity and Quality. Closely connected with the seasonal nature of agricultural marketing is the variation in the amount and quality of the crop from year to year. Such variations lead to fluctuations in market prices as a result of changes in the conditions of supply. The variation in quantity also adds to the difficulties of storage and transportation, for in some years these facilities are taxed beyond their capacity, and at other times they may prove far greater than the need. The variation in quality complicates the problem of grading and makes purchase and sale more difficult. This is especially true in the case of agricultural products used as raw materials, since manufacturers commonly demand standardized materials with particular characteristics. Direct relations between grower and manufacturer are thus handicapped, and a stabilized relationship between supply and demand is difficult to attain.

Bulky and Perishable Products. In addition to the factors just discussed, certain physical characteristics of agricultural products affect their marketing. Most of them are bulky, that is, their weight and volume are great as compared with their value. Transportation and storage are, consequently, difficult and expensive. Some fruits and vegetables, of course, can stand an expensive transportation service because of their high value. But this is not true of most farm products, and the costs of transportation play a large part in determining the extent of market penetration.

Many agricultural products are also exceedingly perishable. There is, however, a wide degree of difference between products, and even between similar products under varying conditions. The present extensive trade in highly

perishable fruits and vegetables, milk and other dairy products, meats, and poultry products is primarily dependent upon relatively recent improvements in refrigeration and transportation. Even cereals, tobacco, and cotton, which can be stored for a considerable period of time without deterioration, must be stored under proper conditions and given reasonable care.

Consumption Characteristics

The demand for most agricultural products is relatively inelastic. If a product is in short supply, its price is likely to advance rapidly. If output is large, however, the price may have to fall a great deal to take the supply off the market. There is a limitation to the amount of food which can be consumed, and hence to the possibilities of demand creation. This is in contrast with most other consumer goods, for which the demand is more elastic. It is true that we have seen an increase in the demand for some food products during recent years as a result of rising incomes, but this does not seriously modify the importance of the generalization just made. The greatest problem of agriculture appears to be that of price stability, especially the tendency toward low prices which results from the frequent occurrence of a large supply of products available in the market. The adjustment of supply to demand takes place slowly. For this reason, we have had since the early thirties numerous efforts by the federal government to support agricultural prices, efforts that have not been too successful either in maintaining prices or in removing surpluses from the market.[4]

CHANNELS OF DISTRIBUTION

The complexity of the marketing system for agricultural products arises primarily from the need to concentrate the outputs of many relatively small producers into larger lots for economical and efficient marketing. This involves the use of more wholesale middlemen than are necessary for the marketing of manufactured products. The latter are likely to utilize at most the efforts of only one or two wholesalers, and these are concerned largely with the dispersion of the goods. Agricultural products, however, may require one or two wholesalers to perform the work of concentration and a like number for the process of dispersion. It will assist us in understanding the channels of distribution for specific agricultural products if we first take note of the various types of agricultural wholesale markets.

[4] Agricultural price legislation will be discussed in Chap. 30.

Types of Wholesale Markets

Four classes of wholesale markets for agricultural products may be distinguished: (1) local markets, (2) central markets, (3) jobbing markets for consumer goods, and (4) secondary markets for raw materials. Not all agricultural products pass through each of these applicable markets. As in the case of manufactured goods, there is a certain amount of direct selling and buying and the available wholesale market middlemen are not always utilized. Most agricultural products, however, are marketed through at least one wholesaler and often through several.

Local Markets. Local markets, sometimes called "local assembling markets" or "growers' markets," are found close to the areas of production. Operating in these markets are numerous wholesalers and cooperative associations who assemble farm products for further shipment in large quantities. The wholesalers are known by various names: cash buyers, resident buyers, packer-shippers, local or country elevators, order buyers, and the like. But regardless of the name or the type of operation, it is the function of local market middlemen to provide a convenient place at which the grower can sell his product and to facilitate the collection of products from the surrounding area in sufficient quantities for economical shipment. In order to perform these services, local markets usually provide facilities for weighing, storing, loading, and in some cases, as with fruits, for sorting, grading, and packing.

The assembling of agricultural products in local markets is the first step in concentrating them at the central wholesale markets. This operation is necessary because it would be inconvenient and too expensive for most central market buyers to establish direct business relationships with the many producers of the farm products they desire to purchase. The average farmer, likewise, finds it inconvenient and too expensive to establish business connections at central markets. Furthermore, if such connections were established, the small volume which many growers are able to market would be shipped in less-than-carload lots, at rates which are considerably higher than carlot rates.

Central Markets. Central wholesale markets, often called "terminal markets," are those in which products are concentrated in large volume from local markets and in some cases directly from growers. Some of these products are used in the factories of the central markets' metropolitan area and others are sold to jobbers and retailers for local consumption. In addition, substantial amounts of some products are reshipped to other cities for sale to dealers in secondary or jobbing markets, to mills and factories, or to retail dealers.

Price determination takes place largely in the central markets. It is here that buyers and sellers are brought together and that the forces of demand and supply meet. The adjusting of demand and supply has been said to be the principal function of central markets.[5]

Thus the processes of concentration, equalization, and dispersion converge in the central wholesale markets. These markets are found in cities located strategically between the producing and consuming areas and possessing superior transportation facilities. Here are found warehouses, banking and credit agencies, exchanges, and other institutions so important to successful marketing. Because of their facilities and because of their strategic location and the large volume of products used in the immediate area, it is but natural that producers turn to such cities for a market in which to sell, and that buyers look to them as a source of supply. As a result, the facilities of such markets are usually capable of handling a greater volume of business than would be necessary for purely local consumption. Chicago, St. Louis, Kansas City, and Minneapolis, strategically located in relation to the centers of grain and livestock production and the centers of manufacturing and consumption, are important central markets for these products. Omaha, St. Paul, and Denver are other important central markets for livestock. Memphis, Dallas, Houston, and New Orleans are important central markets for cotton, the latter two primarily because they were originally transshipment points between rail and water. The great consuming centers of the nation, such as New York, Philadelphia, Chicago, and Los Angeles, constitute important central markets for fresh fruits and vegetables.

Wholesalers operating in the central market who buy in large quantities and who take title to the product may be designated as "wholesale receivers," the actual title used depending upon the commodity they handle. Also operating in the central market are numerous agent middlemen—brokers, commission men, and auction companies—who assist in bringing buyers and sellers together but who do not take title. These middlemen, together with numerous facilitating agencies, carry out the functions of the central market.

Jobbing Markets. The basic function of jobbing markets is to disperse agricultural consumer goods such as fresh fruits and vegetables, poultry, eggs, and dairy products. Jobbers assemble goods in quantity from central market receivers and sell them in smaller lots to retail stores and institutions. In modern marketing, much of the distinction between central markets and jobbing markets has been eliminated. Central market receivers have tended to act in a jobbing capacity by selling in smaller and smaller quantities and

[5] Edward A. Duddy in *Marketing: The Yearbook of Agriculture, 1954* (Washington, D.C.: U.S. Department of Agriculture, 1954), p. 38.

thus to serve retailers directly. Retail food stores, since the advent of the supermarket, have become larger and larger until they have attained a scale of operation permitting them to buy directly from central market middlemen. Jobbers, especially those located in smaller cities, who once relied upon the central market of a nearby large city for supplies now may buy directly from local markets. Moreover, chain store systems have tended more and more to purchase directly from local markets and from large growers and thus to bypass both the central market receiver and the jobber.[6]

The distinction between central market operations and jobbing operations still has some usefulness, however, and most large cities do have primary and secondary markets regardless of the exact nature of their operations. For example, the Washington Street market in New York and the South Water market in Chicago may be regarded as primary central markets as well as important jobbing markets. On the other hand, the Gansevoort market in New York and the Randolph Street market in Chicago are small jobbing markets which obtain their supplies almost entirely from the larger central markets and break them down into smaller lots for resale. In a similar way, small jobbers in outlying cities will usually rely on the nearest primary market for a considerable portion of their goods. Thus jobbing markets tend to operate on a smaller scale than do central markets, do not play so large a part in the determination of prices, and perform only those operations which enable them to supply their immediate retail clientele.

Secondary Markets. Secondary wholesale, or subterminal, markets perform for agricultural raw materials a function similar to that performed for agricultural consumer goods by the jobbing markets. The middlemen operating in these markets are concerned mainly with the dispersion process, assembling raw materials from central markets for resale to local mills and factories. As is the case with consumer goods, the distinction between central and secondary markets for raw materials has tended to become somewhat blurred. Secondary market middlemen often purchase directly from local markets and from growers, thus engaging in the concentration of goods as well as in their dispersion. Processors located in secondary markets also tend to buy from central market receivers in some instances, as well as directly from local markets. Nevertheless, there is again a useful distinction to be made between the two markets, a distinction which assists in understanding the rather complex system of marketing agricultural products.

[6] Even though middlemen may be eliminated, the functions that they normally perform must be assumed by someone. Chain store systems, for example, assume the functions of central market receivers and jobbers and in some instances perform them in a manner very similar to that used by the traditional agencies.

Channels for Consumer Goods

Typical channels of distribution for fresh fruits and vegetables are shown in Figure 4-1. The channels shown are somewhat oversimplified, since many types of agencies operate in the various product lines. Moreover, no indication

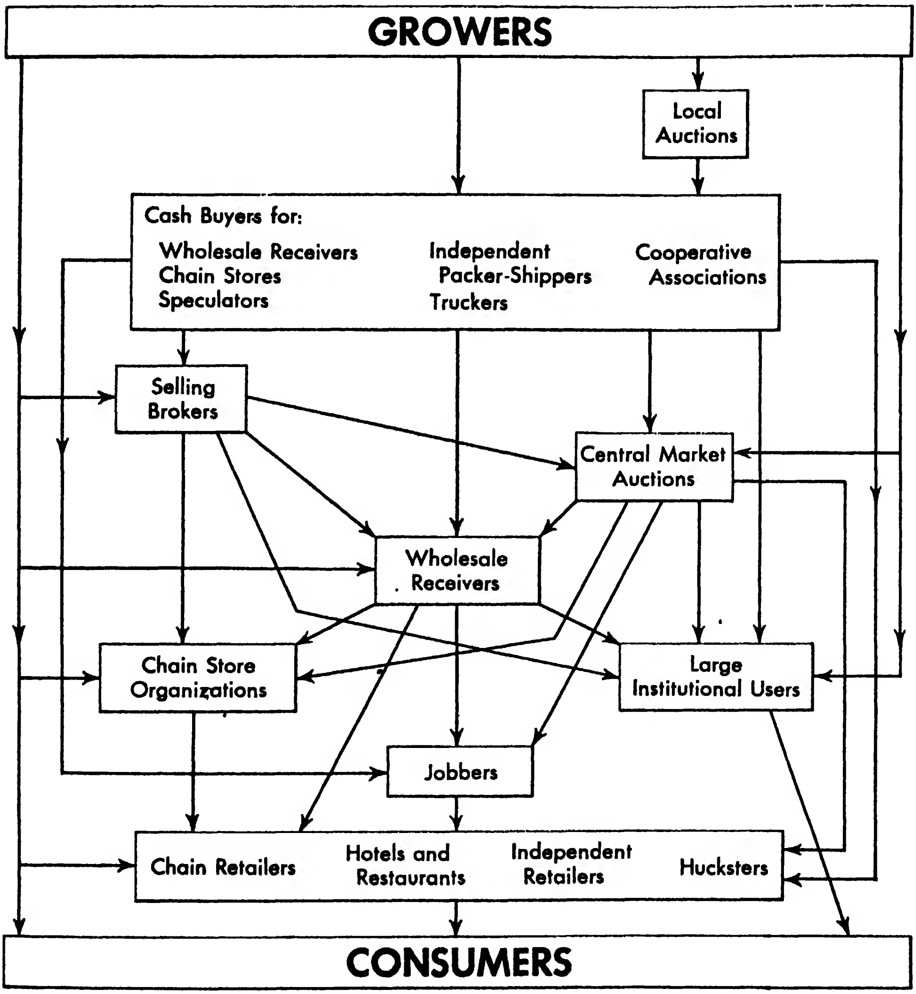


Figure 4-1. Channels of Distribution for Fresh Fruits and Vegetables.

is given of the relative importance of the several channels, which also varies greatly according to the product and to the distance that it must travel to reach the consuming market. However, the diagram does give an idea of the basic channels and their variations. A product moving through the "normal"

channel would proceed from grower to local assembler (such as the cash buyer, independent packer-shipper, or cooperative association) to wholesale receiver with the assistance of one or more agent middlemen (the selling broker and central market auction) to jobber to retailer to consumer. Any or all of these middlemen, however, may be eliminated for one reason or another until we get to the shortest channels of grower to retailer to consumer and even grower directly to consumer.

The channels of distribution for poultry have changed greatly in recent years and in general involve fewer middlemen than in the case of fresh fruits and vegetables. Much of the supply is produced by farmers under contractual arrangements with large processors, feed companies, and others, who assume responsibility for marketing the finished product.[7] Country processing plants have largely replaced city processing, and these plants obtain the bulk of their supplies directly from producers or contractors. They sell the dressed product in turn to city wholesalers or directly to large retailers. The smaller retailers, hotels, restaurants, and institutions usually purchase from the city wholesalers. There are still a few live poultry buyers in the local markets in some parts of the country and some city processing plants, but their importance in the marketing of poultry is declining rapidly.[8]

Selling Through Wholesale Channels. The foregoing illustrations are sufficient to give a general idea of the channels of distribution for agricultural consumer goods. The standard channel, and the one through which the bulk of these products move, involves the use of one or more wholesale middlemen. Usually the producer sells to a local assembler who in turn sells to a wholesale receiver in the central market. A jobber may then be the next link in the channel, but as previously mentioned there is a substantial trend at present to consolidate the functions of the jobber and those of the wholesale receiver into one agency. Transactions between the local assembler and the wholesale receiver may or may not be assisted by agent middlemen located in the central market. Some producers, especially the larger ones, will bypass the local assembler and sell directly to the central market buyer. Chain stores, of course, tend to perform the wholesaling functions themselves and often buy directly from local assemblers or even from large producers. Thus, although it is difficult to determine for a given product the extent to which the complete wholesale channel is used—local market to central market to jobbing market—it is true that the majority of agricultural consumer goods do pass through some portion of it. Moreover, the channel for such products tends

[7] See the discussion on contract farming in a later section of this chapter.

[8] See *The Marketing and Transportation Situation*, Agricultural Marketing Service, U.S. Department of Agriculture, April 1959, pp. 32–7, and October 1959, pp. 25–6.

to be longer and to involve more types of wholesalers than is the case for manufactured consumer goods.

Selling Directly to Retailers. A certain amount of agricultural consumer goods is sold directly by producers to retailers, including hotels and restaurants, thus bypassing the entire wholesale channel. For example, studies of certain areas have shown that producers sell 30 per cent or more of their eggs directly to retailers.[9] For agricultural consumer goods as a whole, the figure is probably less than this, but chain store buyers and even the smaller retailers who are located close to producing areas are in a position to buy fruits, vegetables, eggs, and other consumer goods directly from the producer.

The farmer selling directly to local retailers usually obtains a higher price for his product than could be obtained from local assemblers. If his output is small, he may not find it unduly burdensome to assume the marketing functions involved in direct selling. If his output is large, however, he is likely to find it quite burdensome and expensive to seek out the necessary number of buyers and to perform the necessary marketing functions. In that event, he may well decide that his net return would be greater by selling in large quantities to local assemblers. Obviously, direct sale to retailers is not a practical alternative for producers located at great distances from the major consuming markets, except as it is possible to deal directly with chain store buyers.

To the retailer, the main advantage of direct buying is that it assures him a supply of fresh products in season. But there are important difficulties. He may have to buy from several producers in order to provide a sufficient quantity and variety of products for his customers. This increases the time and effort he must devote to buying. He usually must pay cash to the producer, whereas he may receive credit from the jobber or wholesaler. Again, the source of supply is far from dependable; on any given day, one or more of his producers may fail to deliver. Moreover, the quality and quantity of local crops vary widely from year to year. Obviously, it is not feasible for any except the largest retailers to buy all their agricultural consumer goods directly from producers, since they must deal with a large number of persons located in widely separated parts of the country.

Selling Directly to Consumers. Agricultural products may also be sold directly to consumers, thus eliminating both wholesale and retail middlemen. The volume sold in this way is undoubtedly a small proportion of the total output of agricultural consumer goods. It is estimated that 10 per cent of eggs and 5 per cent of poultry are sold directly to the consumer.[10] Fresh

[9] *Yearbook of Agriculture, op.cit.*, p. 472.
[10] *Ibid.*

milk also may be sold directly, especially in small rural communities, by local producer-distributors. Fresh fruits and vegetables are distributed in this way during the growing season in communities close to production areas.

Methods of Direct Sale. Direct sale to the final consumer usually is accomplished in one or more of four ways: (1) by making delivery to consumers at their homes, (2) through roadside markets, (3) through retail public markets, and (4) by parcel post and express.

Delivery to consumers' homes is a common method of direct sale both for milk and eggs. Regular delivery routes may be maintained by producers even in large cities. With respect to fresh fruits and vegetables, the farmer usually peddles the products from door to door.[11] Obviously, direct delivery to consumers' homes is a more satisfactory method of marketing for products which the consumer purchases at regular intervals and for which he has a consistent demand, such as eggs and milk, than it is for products which are purchased irregularly, such as fresh fruits and vegetables.

Roadside markets, or stands, are located on or near the farm, usually on a well-traveled highway near a community of at least moderate size. In this method of selling, consumers come to the farm—the reverse of the method previously described. Fresh fruits and vegetables constitute the principal class of products sold through roadside markets, about 85 per cent of all products sold in this manner.[12] Other commodities sold through roadside markets include eggs, poultry, honey, and maple products. The bulk of the sales are made during the home canning and freezing season, i.e., during the summer months, especially August.

Although relatively unimportant, retail public markets for the sale of agricultural products—commonly called "farmers' markets" or "farmers' retail markets"—are found in many cities. The characteristics of these markets vary greatly. They may be publicly, cooperatively, or privately operated. The market place may be in an open space or in buildings. Space in open markets is often provided without charge by the city. In covered markets a charge for space is ordinarily made. In some cities, the farmers' market forms a section of the public wholesale market, in which case many of the farmers sell both at wholesale and at retail.

The use of parcel post and express is the least important method of direct marketing of agricultural products and probably is confined at present largely to the sale of choice products at Christmas time and through the Fruit-of-the-Month Club and other similar plans. There is ordinarily no personal

[11] House-to-house peddling of farm products is also carried on by hucksters, who obtain their stock either from the grower or in the wholesale market. This, of course, is not direct selling.

[12] *Yearbook of Agriculture, op.cit.*, p. 24.

contact between producer and consumer, the sale being made by written communication between the two parties. Thus it is difficult to establish business relationships. In addition, transportation and packing costs are high, and the seller undoubtedly encounters additional expenses in keeping individual accounts, making collections, and arranging adjustments.

Conclusions on Direct Sale. The direct marketing of agricultural consumer goods is likely to be practiced most widely when farm prices are low or when the farm unit is relatively small and located near densely populated areas. Under these circumstances, the producer may find that the higher price received for his products will compensate him for the greater time and effort spent in marketing them. On balance, however, the volume of agricultural products sold directly to the ultimate consumer is relatively small. Most farmers are unwilling or unable to spend the time required in selling directly. They prefer to sell quickly in large lots to middlemen—local shippers, commission men, wholesale receivers, jobbers, or retailers—and then to return to the work of the farm. Consumers, likewise, generally prefer to depend on the more certain supplies found in retail stores, and to take advantage of their superior services. The trouble and uncertainty of direct purchase are disadvantages which, for most consumers, are not offset by any superiority of the products purchased directly or any saving in cost. In fact, the prices charged by farmers frequently equal those charged by the retail stores for products of equal quality. Moreover, direct purchase is impossible for most consumers.

Most agricultural commodities are grown far from the chief consuming areas. For example, the fresh fruits and vegetables consumed in our larger cities are grown in a wide area surrounding the city and also in regions not geographically tributary.[13] Even with the development of modern motor truck transportation, it is likely to be physically impossible for the average grower to haul his products to such markets and practically impossible for him to establish satisfactory business connections with consumers. So not only must his goods be shipped by some general transportation agency, but he is likely to find it easier to turn the entire operation, including the sale, over to a marketing specialist. Finally, a product that is consumed out of season usually can best be stored by independent agencies who have the proper facilities, together with the requisite financial resources, and who are in close and constant touch with the market.

[13] In 1952, Cleveland received shipments of fresh fruits and vegetables from 45 states and seven foreign countries. California and Florida were the two most important states of origin. See J. Stanford Larson, *Wholesale Produce Markets*, Marketing Research Report No. 91 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, April 1955), p. 3.

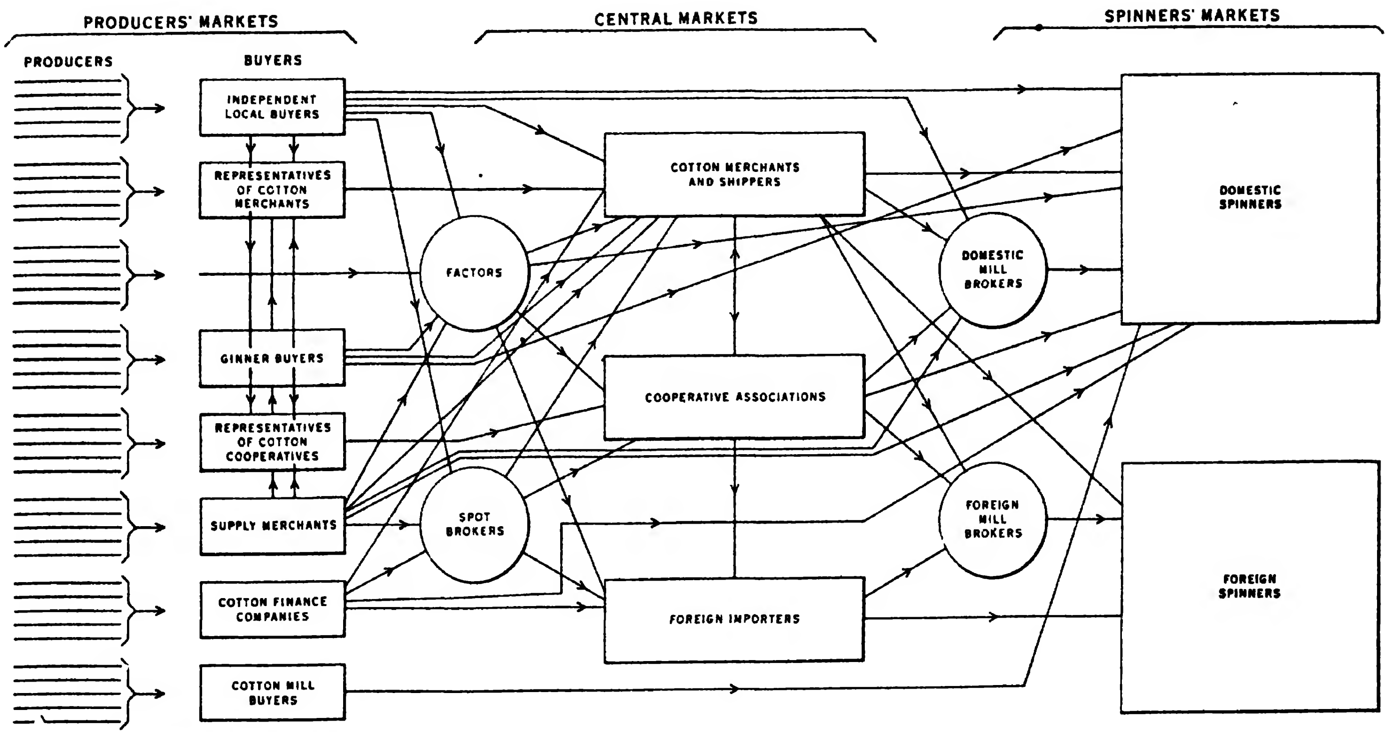
Channels for Raw Materials

The channels of distribution for agricultural raw materials are similar to those for agricultural consumer goods except that the channel for raw materials ends with the sale of the product to processors, mills, and factories. Responsibility for getting the ultimate product to the final consumer rests in the manufactured goods market. Thus raw materials do not flow through the jobbing or retail markets, although they may proceed from central market middlemen to secondary market dealers before final sale to processors.

The channels of distribution for wheat (and other grains) are relatively simple and illustrate the broad pattern for all agricultural raw materials. Farmers sell in the local markets to country elevators which in turn ship to terminal elevators in the central markets. Cash grain commission merchants in the central markets represent the country elevators and arrange for the sale to dealers and other buyers who operate the terminal elevators or who store the wheat in independently operated elevators. These dealers in turn sell to mills and processors. A small amount of wheat is sold directly by the farmer to local mills and a still smaller amount directly to central market dealers. A somewhat larger amount is sold by country elevators direct to mills and factories. The bulk of the product, however, moves through the standard channel—grower to country elevator to terminal elevator and dealer to processor.

The marketing channels for cotton are somewhat more complex and are shown in Figure 4-2. Note that there are several different types of buyers in the local markets and that agent middlemen assist in transferring title not only between local markets and central markets but also between central markets and mill, or spinners', markets. Again, as in the case of wheat, several direct channels are used, as well as the standard local market to central market path.

Wheat and cotton are the best examples of marketing through the traditional local market to central market channel. Secondary market middlemen also may be involved in these products, although there is a strong tendency to combine central market and secondary market operations. For a product such as tobacco, however, the old methods of selling through central markets have almost completely disappeared. About 90 per cent of tobacco is now sold through loose-leaf auctions in the local markets. Most of it is purchased there directly by manufacturers and exporters, although a portion of the purchases are made by dealers and speculators for later resale to the ultimate buyers.



RECTANGLES INDICATE MARKETING FIRMS ACQUIRING TITLE TO THE COTTON   CIRCLES INDICATE FIRMS ACTING IN THE CAPACITY OF AGENT.

Source: U.S. Department of Agriculture, Neg. 33492.

Figure 4-2. Marketing Channels for Cotton Lint.

The marketing of livestock has also been greatly decentralized, as will be shown in the following section, although not to the extent that tobacco has been. Producers are likely to sell either through local market middlemen or through terminal market middlemen but not through both.[14] In a large number of instances, sales are made directly to packers, thus bypassing both local and terminal market intermediaries. All in all, the channels of distribution for livestock have been shortened considerably in recent years.

It is evident from the foregoing discussion that the broad outline of marketing channels is similar for all types of agricultural raw materials but that the relative importance of the several channels varies from one product to another. In recent years, there has been a strong trend toward vertical integration in agriculture which has resulted in the decentralization of agricultural marketing. The decentralization movement has made more progress in some product lines than in others but has affected both raw materials and consumer goods. This trend toward integration and decentralization is of sufficient importance to warrant special discussion.

VERTICAL INTEGRATION IN AGRICULTURE

Vertical integration in agriculture, as in manufacturing, has led to more direct marketing. It has resulted generally in shorter channels of distribution and in the use of fewer dealers and handlers during the marketing process. Two aspects of the vertical integration movement can be distinguished. The first is the decentralization of marketing, that is, the decline in the importance of the central market. The second is the development of contract farming.

The Decentralization of Agricultural Markets

The trend toward decentralization has been in evidence for a number of years but has become somewhat accelerated since the beginning of the

[14] A study of livestock marketing on the Pacific Coast indicates that in 1949 less than 5 per cent of livestock was marketed through both local outlets and terminal markets. About 30 per cent passed through one or more local outlets and about 25 per cent through terminal public markets. The remainder presumably was sold directly to packers and to other farmers. See Harold Abel and Dee A. Broadbent, *Trade in Western Livestock at Auctions*, Bull. No. 352 (Logan: Utah Agricultural Experiment Station, May 1952), p. 47. Nationally a somewhat smaller percentage of total livestock is sold directly to packers and a larger percentage is sold through middlemen. No information is available as to the proportion marketed through both local outlets and terminal markets, but it is unlikely that it is a substantial proportion of total volume. See Victor B. Phillips and Gerald Engelman, *Market Outlets for Livestock Producers*, Marketing Research Report No. 216 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, March 1958).

fifties. Many of the older central markets no longer dominate the marketing of particular farm products as they once did. This is especially true in the case of livestock. For example, in 1925 about 75 per cent of hogs, 85 per cent of sheep and lambs, and 90 per cent of cattle were sold through terminal markets; whereas in 1956 only 37 per cent of hogs, 45 per cent of sheep and lambs, and 70 per cent of cattle were so marketed.[15] Between 1930 and 1955, the number of hogs sold through the Chicago terminal market actually declined from 8,000,000 to less than 3,000,000, and as of 1959 the total number of livestock sold through the Chicago market was less than one third the number sold annually during the twenties.[16] There have also been significant changes in the marketing of butter. At one time, most of the butter sold by creameries passed through the central markets; in 1951 it was estimated that less than 20 per cent of total output was handled by central market wholesalers.

Similar, but perhaps less drastic, changes have taken place in the marketing of grain, fresh fruits and vegetables, eggs, and other products, although specific data are difficult to obtain. For some of these products, especially the grains, the central market is still of substantial importance as a transaction center[17] and thus continues to dominate the process of equalization. That is, the direct movements of the products and the price-making forces are still controlled from the central market to a greater extent than would be indicated by the actual physical movement of the product to that market. For most agricultural products, however, the process of equalization, as well as those of concentration and dispersion, has been decentralized substantially, and the central markets have declined a great deal in relative importance and often in absolute importance.

Causes of Decentralization. This trend toward decentralization has resulted from a number of factors, two of the most important being improvements in transportation and communication. The central market system developed originally largely because of the need to concentrate agricultural

[15] These and other statistics in this paragraph are from R. L. Kohls, "By-Passing of Terminal Market Facilities in Agricultural Marketing," in Robert D. Buzzell (ed.), *Adaptive Behavior in Marketing* (Chicago: American Marketing Association, 1956), pp. 88–9; Edward Uvasek and Dalton L. Wilson, *Livestock Terminal Markets in the United States,* Marketing Research Report No. 229 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, January 1959), p. 10; and Geoffrey Shepherd in *Marketing: The Yearbook of Agriculture, op.cit.*, pp. 52–9.

[16] As a result, two of the nation's major meat packers suspended slaughtering operations in Chicago during 1959. The other member of the "Big Three" ceased operations four years earlier. The Chicago public market still remains, however, an important concentration point for cattle because of superior grading facilities even though the animals may be shipped East for slaughter.

[17] Edward A. Duddy, *op.cit.*, p. 41.

commodities into large lots for economical shipment and because inadequate communication facilities made it necessary for buyers and sellers, or their representatives, to congregate in a central location. In addition, the lack of adequate standards for farm products and the high degree of perishability of some commodities made it necessary to sell by inspection rather than by sample or description.

With the advent of motor truck transportation, it became possible for the grower to sell in smaller quantities and to deal directly with buyers who desired to purchase in these quantities. Better communication facilities, especially the development of radio, permitted a more widespread and rapid dissemination of market news concerning prices and supplies. Thus the grower, or his local market representative, could make decisions regarding the sale of the product without having to rely so completely on central market middlemen at distant points. In addition, standards and grades were developed for many products and new refrigeration equipment reduced perishability. Thus it became somewhat less necessary for the buyer to inspect each purchase made.

These developments then set the stage during the twenties for the movement toward decentralization, a movement the impetus for which came largely during the twenties and thirties from the establishment of large-scale marketing agencies at both ends of the distribution channel. A substantial development of growers' marketing cooperatives took place during the twenties.[18] These cooperatives were able to provide selling services for the grower that previously could be provided only by central market middlemen. This fact, together with the improvements in transportation and communication already noted, made it possible to bypass the central markets at least to some extent. At the other end of the distribution channel, the chain store and the supermarket were beginning to develop into large-scale retailing agencies. These large retailers preferred to purchase agricultural consumer goods directly from local markets and to perform the wholesaling functions themselves. Thus a further decline in the importance of wholesale markets took place with respect to such products as butter, eggs, poultry, and fresh fruits and vegetables. After World War II and particularly during the fifties, food retailers continued to grow in size until two thirds of retail grocery sales were being made by 10 per cent of the unit stores. More and more agricultural consumer goods were being purchased directly rather than through the terminal markets.[19]

[18] A detailed discussion of the cooperative marketing of agricultural products will be found in Chap. 17.

[19] For a more complete discussion, see Norman R. Collins and John A. Jamison, "Mass Merchandising and the Agricultural Producer," *Journal of Marketing,* April 1958, esp. pp. 361–6; and Willard W. Cochrane, "Changing Structure of the American Economy: Its

Results of Decentralization. It is generally assumed that the decentralization of agricultural marketing, to the extent that it has taken place, has resulted in greater marketing efficiency and lower costs.[20] Although data with respect to relative costs are limited and direct comparisons are difficult to make, it seems likely that costs have been reduced. Otherwise, the decentralization movement probably would not have continued to grow to the extent that it has. This does not mean, however, that the central markets can be completely eliminated. Although most authorities expect further decentralization,[21] it should be held in mind that central markets still exist, that substantial proportions of some agricultural products are still sold through them, and that they do serve—and no doubt will continue to serve—under certain conditions a necessary and useful function in the marketing of most farm products.

Actually, there are some inefficiencies in the decentralized marketing system when compared with greater centralization. Buyers may have to go to considerable expense to seek out sellers with the proper quality and quantity of product. There is evidence that for some products "decentralization has resulted in too many and too small individual firms for low-cost operation."[22] Concern is frequently expressed that the decentralization movement, especially with respect to livestock, has complicated the price-making process.[23] There is less tendency to have a definite and specific central market price that is well publicized and known to all sellers and buyers. The individual farmer selling livestock directly from his farm to a local buyer at a negotiated price must make greater effort to become informed with respect to prices in other markets than formerly was necessary. At the same time, with "thin" markets, it may be more difficult for him to obtain reliable price quotations.

Thus it may be seen that there are disadvantages and problems with respect to decentralization as well as benefits. On balance, the result has probably been a net benefit. In any event, it has given the grower, the local market dealer, and the ultimate business buyer somewhat more control over the marketing process than they formerly were able to exert.

Implications for the Performance of Agricultural Markets," *Journal of Farm Economics*, May 1959, esp. pp. 401–7.

[20] See, for example, Geoffrey Shepherd, "Decentralization in Agricultural Marketing—Causes and Consequences," *Journal of Marketing*, April 1942, Part 1, pp. 342–4.

[21] See, for example, Harry C. Trelogan in *Adaptave Behavior in Marketing, op.cit.*, pp. 95–7.

[22] R. L. Kohls in *Adaptive Behavior in Marketing, op.cit.*, p. 93.

[23] See Edward A. Duddy, *op.cit.*, p. 42. Also note Shepherd's discussions both in the *Journal of Marketing, op.cit.*, pp. 346–7, and in the *Yearbook of Agriculture, op.cit.*, pp. 56–8.

Contract Farming

The second principal aspect of agricultural integration is the development of contract farming which has been taking place since the early fifties.[24] There has always been a certain amount of contracting between processors and farmers, as well as between cooperative associations and farmers, whereby the latter agree in advance of actual production to sell their output to the former. For example, written contracts covering the production of specific crops have been common in the vegetable processing and sugar beet industries, such contracts often specifying the number of acres to be produced, the formula for determining prices, the quality of product to be produced, delivery and payment schedules, and other details. Through such contracts, the farmer is assured of a market outlet and the processor of a source of supply.

In recent years, there has been a substantial increase in the use of these contracts. Not only has the practice of contracting been utilized more extensively in the traditional fields, such as vegetable processing; but of greater importance contracting is now practiced rather extensively in several other agricultural industries, especially in poultry and livestock. Moreover, the contract provisions have become more and more exacting with respect to the conditions of production, often specifying for crops the time of planting, the seed and fertilizer to be used, the spraying and dusting operations to be performed, and the time and method of harvesting. Contracts involving poultry and livestock are likely to be even more restrictive with processors and feed dealers virtually taking over responsibility for production. If farmers are reluctant to enter into contracts of the type described, processors often enter the production field directly and grow their own crops or raise their own livestock or poultry.

It is estimated that 90 per cent of the vegetables grown for canning and freezing are either produced by processors or by farmers under contract to them. Contracting is used for almost the entire production of lima beans, sweet corn, and green peas. Sugar beets are grown universally under contract with processors, although this is not a new development But contract production in poultry is a recent development and has progressed rapidly. Some 95 per cent of all broilers are produced under contracts with feed dealers and

[24] Much of the information in this section has been obtained from *Contract Farming and Vertical Integration in Agriculture*, Agriculture Information Bull. No. 198 (Washington, D.C.: U.S. Department of Agriculture, July 1958). See also Willard F. Mueller and Norman R. Collins, "Grower-Processor Integration in Fruit and Vegetable Marketing," *Journal of Farm Economics*, December 1957, pp. 1471–83; and Stanley K. Seaver, "An Appraisal of Vertical Integration in the Broiler Industry," *ibid.*, pp. 1487–97.

processors. About half of the production of turkeys is obtained in the same way. Contract operations in livestock occur principally in the feeding of cattle and lambs, but complete contract production is beginning to take place in hogs. The percentage of hogs raised under contract is still small, perhaps 5 per cent of total production in 1959, but many people expect this to be the next major development in agricultural integration.

Regardless of whether contracts are involved or whether processors are engaged directly in production, it is obvious that the nature of the marketing process has been greatly changed. There is little or no need for concentration of the products in the marketing sense of the term, and production to strict quality standards eliminates the need for the marketing function of standardization. Transfer of ownership either does not take place or has already been provided for in the contract. Thus there is little need for the services of middlemen, especially those located in the local markets. Whereas the decentralization movement previously described results in the bypassing of central markets, grower-processor integration tends to bypass the facilities of the local markets as well. The net effect of these developments is to make the marketing system for agricultural products more akin to that already described for manufactured goods. Nevertheless, the differences previously described in this and the preceding chapters still exist in considerable degree for many agricultural commodities.

QUESTIONS FOR DISCUSSION

1. In footnote 3, the question is raised as to whether cooperative advertising of agricultural products can be effective if there is no control by the advertising organization over the general marketing and sales program of the industry. Why is it necessary to have such control in order to obtain maximum returns from the advertising program?
2. Some people have been critical of the trend toward contract farming and vertical integration of agriculture on the grounds that this is leading to large-scale agriculture, to the elimination of the family farm, and to the loss of the farmer's independence. Assuming that these things might take place to a degree at least, what is the probable effect upon the marketing structure for agricultural products? Will these changes affect the efficiency with which such products are marketed? Do you believe the net effect upon the economy will be beneficial or detrimental and why?

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———, *Contract Farming and Vertical Integration in Agriculture*, Agriculture Information Bull. No. 198 (Washington, D.C.: U.S. Government Printing Office, July 1958).

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PART II

THE CONSUMER AND MARKETING

5. THE CONSUMER MARKET

The ultimate objective of the marketing system outlined in the previous chapters is to serve the final consumer. This is not a new idea but in recent years it seems to have been rediscovered. Accordingly, a great deal of effort is being made by marketing executives to obtain information about consumers: who they are and where they are located, their incomes and consumption patterns, their needs and desires, their motivations and attitudes, and their purchasing habits. It is rapidly becoming "a truism . . . that marketing begins with the consumer and ends with the consumer." [1]

Why has all of this excitement about the consumer suddenly entered the marketing scene? Has the consumer become a more complex individual who is more difficult to serve than he used to be? The answer to this latter question could be argued at considerable length, but it does seem evident that changes in consumer attitudes do take place from time to time.[2] Consider, for example, the growing popularity during the late fifties of the small automobile. The industry trend for many years, as everyone knows, had been toward larger and more powerful cars, with annual model changes of greater or lesser importance, and a constantly increasing number of conspicuous and "flashy" features. The trend was well established and the consumer attitude toward the product apparently very favorable. Within a few years, however, the principal American manufacturers had to bring out additional models, smaller in size and with less power, automobiles with relatively plain features, to meet the competition of foreign and domestic manufacturers who had successfully penetrated the market with just such a product.

Many reasons have been given for the apparent change in the consumer

[1] D. Maynard Phelps in David W. Ewing (ed.), *Effective Marketing Action* (New York: Harper, 1958), p. 5.

[2] See Pierre D. Martineau, "Kaleidoscopic Views of the Consumer Today," in Joseph C. Seibert (ed.), *The Broadening Perspective of Marketing* (Chicago: American Marketing Association, 1956), pp. 40–5; as well as D. M. Phelps, *op.cit.*, pp. 3–9.

attitude toward automobiles—highway congestion and parking difficulties, the increasing cost of gasoline and repair service, and even the psychological one that the automobile is no longer an important symbol of prestige and status. Whatever the reasons, and the most important ones may not even be known, it is obvious that those manufacturers and dealers who foresaw the change in attitudes profited a great deal. Perhaps they saw trends in the consumer market which were not evident to others, or perhaps they were merely fortunate in developing the right product at the right time, but in any event it is obvious that every marketer must be alert to consumer wants and desires.

Whether consumers have become more complex individuals who must now be studied with greater care than ever before is perhaps a pointless question. Consumers must be studied, if for no other reason, because of the many changes that have taken place, and that will take place, in the consumer market. In the United States at least, there are more consumers than ever before. Of greater significance, their incomes and levels of living have risen rapidly and are continuing to rise. More people have more purchasing power than ever before, a purchasing power that is being translated into an effective demand for a great variety of products and services. Thus the study of the consumer must start with an analysis of the population, of incomes, and of expenditure patterns—the quantitative aspects of the consumer market. These topics will constitute the subject matter of the present chapter.

POPULATION AND ITS CHARACTERISTICS

Total Population

Although foreign markets are often important, it is obvious that the population of the United States constitutes the principal market for most American businessmen. This population has been a constantly expanding one. Between 1790 and 1860, the rate of growth varied from 32.7 per cent to 36.4 per cent during each decade of this seventy-year period, a very consistent rate of increase. For the next thirty years, the rate of growth amounted to approximately 26 per cent during each decade. Table 5-1 shows the total population and the rates of growth by decades from 1900 to 1960.

During the thirties when population was increasing very slowly, as shown in the table, it was generally estimated that the population of the United States would reach 165 million by the end of the century.[3] The wartime and

[3] Philip M. Hauser, "The Challenge of Tomorrow's Markets," *Journal of Marketing*, July 1959, p. 1.

TABLE 5-1

Population of the United States [a] and Rates of Growth by Decades, 1900–1960

Year	*Population*	*Per Cent Increase During Decade*
1900	76,212,168	21.0
1910	92,228,496	21.0
1920	106,021,537	15.0
1930	123,202,624	16.2
1940	132,164,569	7.3
1950	151,325,798	14.5
1960	179,323,175	18.5

[a] Includes data for Alaska and Hawaii.

Source: 1960 Census of Population, *Advance Reports,* PC(Al)-1 U.S. Department of Commerce, Bureau of the Census, November 15, 1960, p. 3.

postwar marriage and baby boom changed the picture a great deal; in fact, the 165 million mark was passed in 1955. Present estimates anticipate a population in 1970 of between 202 and 220 million persons, depending upon the assumptions made.[4] Thus the present relatively high rate of population growth is expected to continue, although it should be clearly understood that present *rates* of increase are considerably below those of the nineteenth century when the population base, i.e., the total number of persons, was much smaller.

Geographical Distribution

Although it is of considerable importance to the marketing executive to know that our total population is increasing at a significant rate, it is of even greater importance to realize that this rate of growth is by no means uniform throughout the country. The data in Table 5-2 show that the western states of the Mountain and Pacific regions are growing the most rapidly of any of the eight census regions. The South Atlantic region [5] has had an above average growth since 1940, while the East North Central area [6] has recorded an average rate of increase. The five remaining regions have not maintained

[4] Bureau of the Census, *Current Population Reports,* Series P-25, No. 187, November 10, 1958.

[5] Includes the District of Columbia and the states of Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, and Florida.

[6] Illinois, Wisconsin, Michigan, Indiana, and Ohio.

TABLE 5-2

Percentage Increases in Population, United States and Regions, 1940–1950 and 1950–1960

Geographical Region	*Per Cent Increase 1940–1950*	*Per Cent Increase 1950–1960*
United States	14.5	18.5
New England	10.4	12.8
Middle Atlantic	9.5	13.3
East North Central	14.2	19.2
West North Central	4.0	9.5
South Atlantic	18.8	22.6
East South Central	6.5	5.0
West South Central	11.3	16.6
Mountain	22.3	35.1
Pacific [a]	48.8	40.2

[a] 1940–50 figure does not include Alaska and Hawaii.

Source: 1940–50, *Statistical Abstract of the United States*: 1959 (Washington, D.C.: U.S. Government Printing Office, 1959), p. 13; 1950–60, 1960 Census of Population, *Advance Reports, op.cit.*, p. 3.

growth rates at the level of the United States average.[7] It should be held in mind, of course, that the Middle Atlantic [8] and East North Central states are still the areas of the country in which the population is most heavily concentrated. Almost 40 per cent of the nation's population resides in these eight states compared with about 14 per cent in the South Atlantic area and a similar proportion in the West. The point is, however, that markets are changing and that marketing men must be aware of these changes.

Urban-Rural Distribution

Another change that has been taking place in the distribution of population is that the proportion residing in urban areas has been increasing constantly, with a corresponding decrease in the proportion residing in rural areas. In 1900 about 40 per cent of the people lived in urban communities of 2,500 or more population. The remaining 60 per cent lived in rural communities of less than 2,500 population and on farms. In 1960 these percentages were virtually reversed, 63 per cent being classified as urban residents and 37 per cent as rural. Moreover, another 7 per cent of the population actually

[7] A few individual states located in these regions are exceptions to the general rule, for example, Texas, Connecticut, and New Jersey.

[8] New York, New Jersey, and Pennsylvania.

lived in urban metropolitan areas, although they were classified as rural under the census definitions used prior to 1950. Thus the revised census definitions show 70 per cent urban and only 30 per cent rural population in 1960.

Actually, the relative decline in rural population is more than accounted for by the decrease in the number of persons living on farms. In 1910 about 35 per cent of the nation's population, some 32 million persons, lived on farms. In 1950 farm population amounted to 25 million people, less than 17 per cent of the total, and by 1959 it constituted approximately 21 million persons or 12 per cent of the total population.

Movement to the Suburbs. Even the shift of population to urban areas has not been a consistent one. Since 1940, suburban communities have grown at a much more rapid rate than have the central cities. Between 1950 and 1960, while standard metropolitan areas showed an increase in population of 26 per cent, the central cities of these areas increased by only 11 per cent and the suburban areas outside of central cities increased by 49 per cent.[9] Moreover, the rural areas outside the central cities showed an even larger increase. This indicates that people are moving out farther and farther from the central cities, even beyond the suburbs presently classified as "urban" areas.

For a number of years, marketing students have spoken of the "surburban" market; now they speak of "interurban" markets. An interurban area, or megapolis, is defined as a land strip including two or more metropolitan areas and the surrounding densely populated nonfarm counties. One study has located fourteen interurban markets covering less than 4 per cent of the nation's land area but with almost half of the total population and more than half of all retail sales.[10] The most noteworthy of these land strips of concentrated population is that which extends from north of Boston to south of Washington, D.C., virtually one continuous urban area. Developments of this type have great significance for the future, since these interurban markets will almost certainly grow in relative importance. Many believe that they will constitute the mass markets of the future.

[9] A standard metropolitan area is an integrated economic and social unit established for statistical purposes. It consists of one or more central cities with a population of at least 50,000 plus the county or counties containing the central cities and such contiguous counties as are considered to be economically and socially integrated with the central city or cities. For the exact criteria used in determining standard metropolitan areas, see *Standard Metropolitan Statistical Areas* (Washington, D.C.: Executive Office of the President, Bureau of the Budget, 1959).

[10] "From These City Areas Come Tomorrow's Vast Interurban Markets," *Printers' Ink*, April 26, 1957, pp. 36–41. This is a report of a study, *Interurbia, The Changing Face of America*, presented before the American Association of Advertising Agencies, April 27, 1957, by the J. Walter Thompson Company.

In any event, the shifts in population described above have many implications for marketing. For example, the decrease in farm population, with fewer persons operating larger farms, is related to the increased demand for power machinery. The movement to the suburbs has led to a greater amount of home ownership and a demand for the many products associated therewith, including lawn and garden furniture and equipment, all products having to do with outdoor living, and do-it-yourself tools and equipment. By virtue of his location, the suburban dweller finds it inconvenient to shop in the city center of the adjacent central city. Thus we have had the development of suburban shopping centers and branch stores, as retailers have tended to move closer to their customers. All in all these population shifts have had, and will continue to have, a very significant effect upon the location of markets and the demand for various types of products.

Age Distribution of the Population

Significant changes have also been taking place in the distribution of the population by age groups. Between 1920 and 1950, the median age of the population increased from 25.3 to 30.2 years. Due to advances in medical science and care, people are living longer and the average age of the population will continue to increase in the long run. For the present, however, the low birth rate of the thirties coupled with the high rate of the forties and fifties has resulted in the stabilization of the median age, an interruption of the long-run trend.

Of particular significance to marketing are the changes in the composition of the various age groups. Between 1950 and 1958, the total population increased by about 15 per cent, but the age group of five to thirteen years increased by 40 per cent. The next highest gains were obtained in the fourteen to seventeen group, about 26 per cent, and in the sixty-five and over group which increased by 23 per cent. The number of people between eighteen and thirty-four years actually showed a decline.[11] Projecting the population figures into the future, we find that the fourteen to seventeen age group is expected to increase by about 50 per cent by 1970 compared with 1957, and the eighteen to twenty-four group by about two thirds. The gains in the sixty-five and over group will continue at least until 1980, at which time there may be a temporary leveling off.[12]

There are obvious implications for marketing in these figures. More at-

[11] *Current Population Reports, op.cit.,* Series P-25, No. 193, February 11, 1959.

[12] *Current Population Reports, op.cit.,* Series P-25, No. 187, November 10, 1958. See also Philip M. Hauser, *op.cit.,* p. 6.

tention is being, and will be, paid to the over sixty-five market and to the needs of retired people. At the same time, assuming the continuance of the birth rate level of recent years, the subteen and early teenage market will continue to be a very important one. Of greatest interest is the fact that, beginning in the middle sixties, there will be a substantial increase in the rate of new family formation, as those born in the forties reach adult status and marry. This should result in a large demand for housing, furniture and furnishings, and all of the other goods and services required for establishing a household. All of this assumes, of course, that our technology and labor productivity will continue to make advances so that there will be available employment at high rates of pay for these new entrants into the labor force. There is every reason to assume that this will be the case. In fact, during the past 150 years, countries with the most rapidly growing populations have had also such great advances in technology that their per capita incomes have risen steadily.[13]

Number and Size of Households

The discussion of population thus far has been mostly concerned with individuals. Since many products are purchased and used by households,

TABLE 5-3

Estimated Number of Households for the United States, Rates of Growth, and Population per Household, Selected Years

Year	*Number of Households (in thousands)*	*Per Cent Increase During Period*	*Average Population per Household*
1900	15,992	—	4.63
1910	20,183	26.2	4.45
1920	24,467	21.2	4.24
1930	29,997	22.6	4.00
1940	35,153	17.2	3.66
1950	43,554	23.9	3.37
1958	50,402	15.7	3.35

Source: Current Population Reports, op.cit., Series P-20, No. 92, March 5, 1959.

rather than by individuals as such, it is important to consider briefly the number of households in the population. In Table 5-3, data are presented

[13] Everett E. Hagen, "Population and Economic Growth," *American Economic Review*, June 1959, p. 326.

showing changes in the number of households during recent years. It is evident that the number of households, which includes both families and individuals living alone, has been increasing more rapidly than the population in general and that the average size of household has been declining. For example, between 1940 and 1950, although population increased only 14.5 per cent (see Table 5-1), the number of households increased 23.9 per cent. Similar results are evident for the other periods.

Several conclusions can be drawn regarding the effects of these trends on markets. The decreasing size of the family presumably has been one of the factors responsible for the movement toward smaller houses, which require less furniture and other similar items. However, the average size of younger families appears to be increasing—the evidence is in the higher birth rate of recent years—and there are definite indications of a movement back toward larger houses. Moreover, with households being established at a more rapid rate than would be indicated merely by the growth in population, the market for items for which the family is the consuming unit—such as furniture and other consumer durables—is probably increasing more rapidly than is the market for many items for which the individual is the consuming unit.

At present the rate of new household formation is declining and is expected to continue to do so until 1965. The sharp increase that will take place after that date, however, will bring the total number of households in 1975 to an estimated 64 to 69 million, with the significance to marketing that has already been mentioned. During this period, the average size of household is not likely to be a significant marketing factor. It will probably hold approximately at present levels. Apparently, the greater number of older people, which results automatically in an increase in small households, will offset for some time the greater number of larger families brought about by the higher birth rate. In addition, there is a tendency at present for older people to maintain their own households rather than to live with their children as was once the case. Finally, the anticipated high rate of new family formation after 1965 should result in an increase in the number of households and in a reduction of the average size of family, at least for a time.

INCOME AND ITS DISTRIBUTION

People alone do not make a market. This is evident when we think of the many areas of the world with large populations which do not constitute an effective market for consumer goods and services because of a lack of purchasing power. Thus the businessman with goods to sell is even more

interested in the amount of income that people have in his market area than he is in the number of people.

Total Income

Personal income in the United States, that is, the income received by persons from all sources, has increased greatly in recent years. At the same time, tax payments to government have also increased substantially. When tax and nontax payments to government are subtracted from personal income, the result is called "disposable personal income." This is the amount of money that people have available for the purchase of consumer goods and services. A certain amount of this disposable personal income ordinarily is saved. The balance is spent for goods and services and is designated as "personal consumption expenditures."

Information is given in Table 5-4 showing personal income, disposable personal income, and personal consumption expenditures for certain years

TABLE 5-4

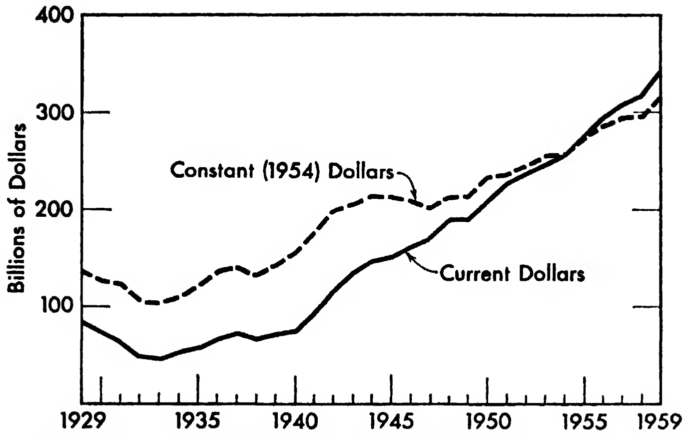
Personal Income, Disposable Personal Income, and Personal Consumption Expenditures for the United States, Selected Years (in billions of dollars)

Year	*Personal Income*	*Disposable Personal Income*	*Personal Consumption Expenditures*
1929	85.8	83.1	79.0
1933	47.2	45.7	46.4
1937	73.9	71.0	67.3
1940	78.7	76.1	71.9
1943	151.4	133.5	100.5
1947	191.6	170.1	165.4
1949	208.3	189.7	181.2
1951	256.7	227.5	209.8
1953	288.3	252.5	232.6
1955	310.2	274.4	256.9
1957	351.4	308.8	285.2
1958	360.3	317.9	293.5
1959	383.3	337.3	313.8

Source: Survey of Current Business, U.S. Department of Commerce, July 1960, p. 10.

since 1929. Since total retail sales volume and the retail sales for many categories of products correlate closely with disposable personal income, let us

look briefly at this series. The increase in disposable personal income between 1929 and 1959 is more than 300 per cent. The increase in real income, however, as shown in Figure 5-1, is not that great. Part of the increase has been caused by a decline in the purchasing power of the dollar. Taking this factor into account, the real increase in disposable personal income between these two years is about 130 per cent. This latter figure indicates more accurately



Source: Data from *Survey of Current Business*, July 1960, p. 10.

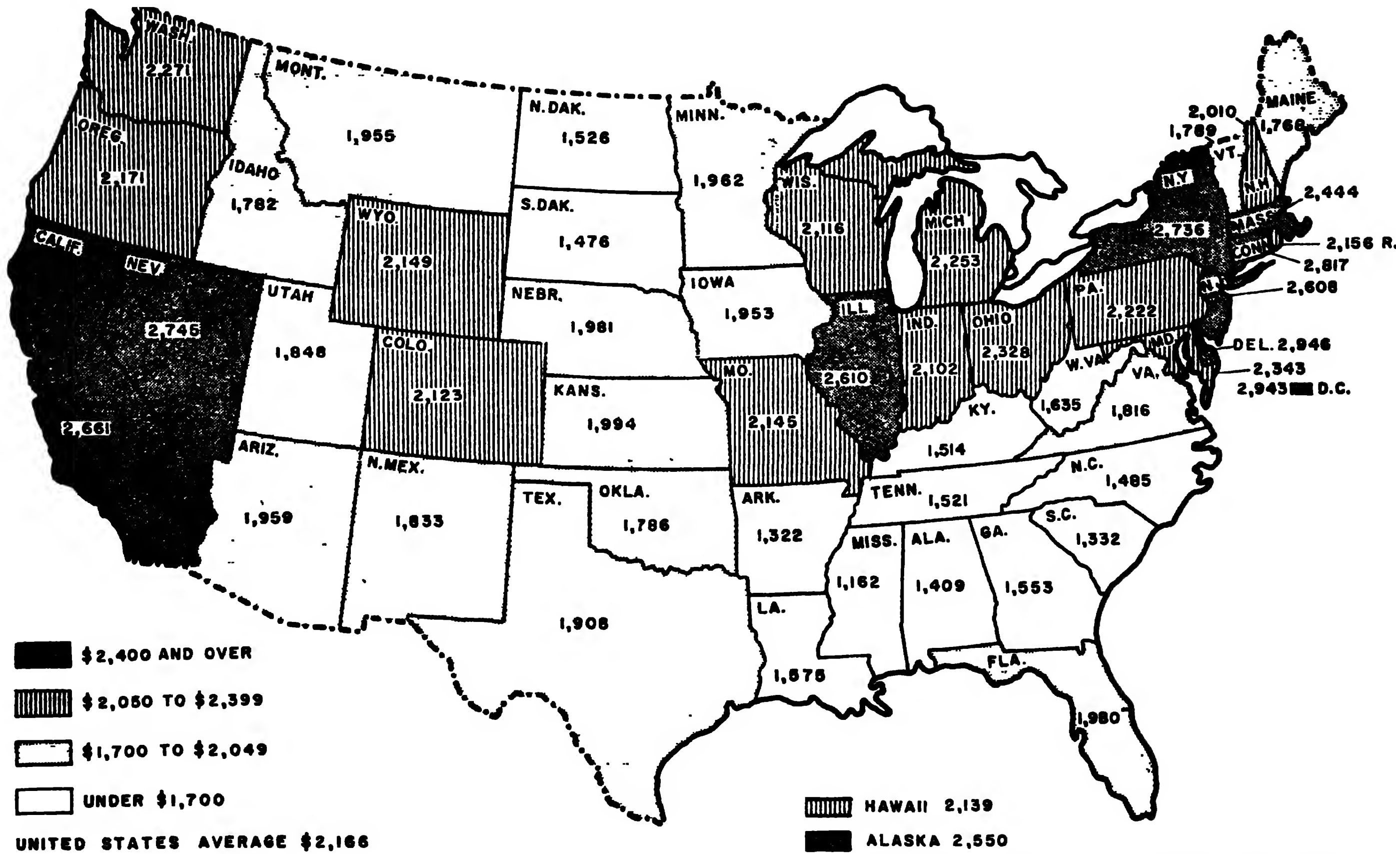
Figure 5-1. Disposable Personal Income for the United States in Current and Constant (1954) Dollars, 1929–1959.

the real change in disposable personal income between 1929 and 1959, but even this represents a substantial increase.

Geographical Distribution

The average income per person in the United States in 1959 was $2,166. There are substantial differences, however, in the average incomes from one geographic region to another. Figure 5-2 shows the per capita incomes for each state in 1959. Thus it is evident that certain regions of the country constitute better markets than do other regions. It is often the case that the more heavily populated areas of the country also have the highest per capita income. These areas represent then the prime markets for consumer goods and services.

Some changes in these markets are taking place, however. We have previously noted the changing geographical distribution of population. In the same way, the rate of increase in incomes in recent years—although not necessarily the absolute increase in dollar amounts—has been greater in the



Source: *Survey of Current Business*, August 1960, p. 17

Figure 5-2. Per Capita Personal Income by States in Dollars, 1959.

low income regions. Between 1929 and 1957, for example, the increase in per capita personal income for twelve southern and southeastern states amounted to 288 per cent and for four southwestern states to 270 per cent compared with an increase for the entire United States of 188 per cent.[14]

Personal Distribution of Income

In 1959 the median income for all consumer units, consisting of families and unattached individuals, was approximately $5,300 before federal income taxes, while the mean income was $6,520.[15] Table 5-5 shows the average

TABLE 5-5

Average (Mean) Income of Consumer Units in the United States Before and After Federal Income Taxes, in Current Dollars and in Constant Dollars, Selected Years

	Income Before Taxes		*Income After Taxes*	
Year	*In Current Dollars*	*In 1959 Dollars*	*In Current Dollars*	*In 1959 Dollars*
1929	2,340	4,100	2,320	4,070
1947	4,130	5,290	3,720	4,770
1950	4,440	5,340	4,070	4,890
1953	5,390	5,900	4,810	5,260
1956	6,010	6,370	5,400	5,730
1958	6,260	6,330	5,650	5,710
1959	6,520	6,520	5,880	5,880
Per Cent Increase 1959 over 1929	**179**	**59**	**153**	**44**
Per Cent Increase 1959 over 1947	**58**	**23**	**58**	**23**

Source: Survey of Current Business, April 1960, p. 9; percentages computed by the writers.

(mean) incomes for all consumer units for various years, both before and after federal income taxes. It will be noted that the increase in the average income that took place between 1947 and 1959 was a substantial 58 per cent. The increase in real purchasing power, however, was only 23 per cent. Like-

[14] See *U.S. Income and Output* (Washington, D.C.: U.S. Department of Commerce, 1958), p. 33.

[15] Selma F. Goldsmith, "Size Distribution of Personal Income, 1956–59," *Survey of Current Business*, April 1960, p. 8.

wise, the increase in average income in current dollars between 1929 and 1959 amounted to a great deal more than the increase when measured in purchasing power—179 per cent as compared with 59 per cent. When differences in federal income tax are taken into account, the increase in real purchasing power for nongovernmental goods and services is only 44 per cent. Nevertheless, this represents a substantial gain in market opportunity.

Of even greater importance than the increase in average income is its distribution. The data in Table 5-6 show that the income gains that have

TABLE 5-6

Income Distribution of Consumer Units in Constant Dollars for the United States by Number of Units and Per Cent of Total, Selected Years

Annual Income in 1957 Dollars (before federal income taxes)	*Number of Consumer Units (in millions)*			*Per Cent of Total Consumer Units*		
	1929	*1947*	*1957*	*1929*	*1947*	*1957*
Under 2,000	12.4	8.0	7.3	34	18	14
2,000–3,999	14.0	13.7	12.1	39	31	23
4,000–5,999	5.1	11.5	13.6	14	25	25
6,000–7,999	1.7	5.6	9.6	5	12	18
8,000–9,999	1.2	2.5	4.8	3	6	9
10,000 and over	1.7	3.4	6.1	5	8	11
Total	**36.1**	**44.7**	**53.5**	**100**	**100**	**100**

Source: U.S. Income and Output, op.cit., p. 45; *Survey of Current Business*, April 1958, p. 13; percentages for 1929 and 1947 computed by the writers.

taken place since 1929 have been well distributed and the lower income groups have benefitted a great deal. In 1929, 73 per cent of all consumer units had incomes of less than $4,000, measured in terms of 1957 dollars. By 1947, the comparable figure had dropped to 49 per cent, and in 1957 it was only 37 per cent. Correspondingly, in 1957, 43 per cent of consumer units had incomes between $4,000 and $8,000 compared with only 29 per cent in 1929.

Thus there has been a significant increase in the middle income group in recent years, not only relatively but also absolutely because of the large increase in the number of consumer units. The mass market of the twenties and thirties consisted of the 26 million families (see Table 5-6) in the lower income groups—those with incomes of less than $4,000 in 1957 equivalent dollars. The mass market of the present consists of the 28 million families

TABLE 5-7

Personal Consumption Expenditures for the United States by Type of Product, Selected Years

Type of Product	Expenditures (in millions of dollars)				Per Cent of Total Expenditures			
	1929	1937	1947	1957	1929	1937	1947	1957
Food	19,535	16,414	45,785	66,427	24.7	24.4	27.7	23.3
Alcoholic Beverages and Tobacco [a]	1,695	5,138	12,489	15,214	2.2	7.6	7.5	5.3
Clothing, Accessories, and Jewelry	11,193	8,092	22,952	29,985	14.2	12.0	13.9	10.5
Personal Care	1,116	961	2,253	3,963	1.4	1.4	1.4	1.4
Housing	11,446	8,436	15,567	35,367	14.5	12.6	9.4	12.4
Household Operation	10,735	9,525	23,949	39,984	13.6	14.2	14.5	14.1
Medical Care and Death Expenses	3,544	3,180	7,685	16,399	4.5	4.7	4.6	5.8
Personal Business	5,086	3,663	5,707	15,736	6.4	5.5	3.5	5.5
Transportation								
User-Operated	5,960	5,288	12,316	33,054	7.6	7.9	7.4	11.6
Other	1,652	1,229	3,074	3,291	2.1	1.8	1.9	1.2
Recreation	4,331	3,381	9,352	15,908	5.5	5.0	5.6	5.6
Private Education and Research	664	600	1,411	3,047	0.8	0.9	0.9	1.1
Religious and Welfare Activities	1,196	900	2,032	3.607	1.5	1.3	1.2	1.3
Foreign Travel and Remittances (net)	799	452	837	2,460	1.0	0.7	0.5	0.9
Total	78,952	67.259	165,409	284,442	100.0	100.0	100.0	100.0

[a] The figure for 1929 is for tobacco only.

Source: 1929 and 1937 data from *National Income: 1954 Edition* (Washington, D.C.: U.S. Department of Commerce, 1954), pp. 206, 208; 1947 and 1957 data from *U.S. Income and Output*, *op.cit.*, pp. 150–2. Percentages computed by the writers.

with incomes of $4,000 to $10,000, and the mass market of the seventies is expected to consist of families with a considerably higher income, on the average perhaps as much as $7,500 in 1957 dollars.[16] The outstanding development during recent decades with respect to income, then, is the emergence of a large middle income group. Moreover, the income level of this group is sufficiently high that it has a great deal of flexibility in its spending patterns, as will be seen in the following section.

CONSUMER EXPENDITURES

The Expenditure Pattern for the Economy

Although it is not possible in the space available to analyze consumption expenditures in detail, information is presented in Table 5-7 for broad categories of goods and services for selected years. The data on total personal consumption expenditures in Table 5-4 indicated the great increase that has taken place in the past three decades, although much of the increase, of course, is due to the rise in the general price level. Table 5-7 shows the breakdown of personal consumption expenditures not only in actual dollars spent but also in percentages of total expenditures. Thus it is possible to see the general spending pattern for the economy as a whole, as well as changes in that pattern.

Probably the most definite and consistent trends shown by the percentage figures are the increases in expenditures for automobiles and their operation (user-operated transportation) and for private education. The proportionate expenditure for medical care also was considerably higher in 1957 than for the other three years. At the same time, the relative expenditures for clothing and accessories and for public transportation (other transportation in the table) have shown a rather consistent downward trend, and those for food and alcoholic beverages were lower in 1957 than for previous years.[17] The expenditures for housing have shown considerable fluctuation as a result of wartime controls and postwar materials shortages, but as of 1957 they were regaining their prewar level. Actually, the data in Table 5-7 show a fair degree of stability in consumer expenditure patterns, more than one might expect considering the great social changes that have taken place during the period.

[16] See, for example, "The Decade of the 'Discretionary' Dollar," *Fortune*, June 1959, pp. 136–8 ff.

[17] The lower 1957 figure for the classification, alcoholic beverages and tobacco, is due to a decrease in proportionate expenditures for alcoholic beverages rather than for tobacco. Note that the 1929 figure excludes alcoholic beverages.

TABLE 5-8

Family[a] Expenditure Patterns of Urban United States by Income Class and Type of Product, Compared with Average Income, 1950

Income Class	Per Cent of Total Expenditures: Food, Beverages, and Tobacco	Housing	Household Operation	Clothing and Clothing Services	Transportation	Medical Care	Personal Care	Recreation, Reading, and Education	Miscellaneous	Total Annual Expenditure for Current Consumption	Average Annual Money Income After Taxes
All Families	33.2	11.5	15.7	11.4	13.4	5.2	2.2	5.9	1.4	$ 3,808	$ 3,910
Under $1,000	35.8	18.7	16.7	6.3	7.2	7.1	2.0	3.4	2.7	1,278	614
$1,000 to $2,000	38.3	15.7	15.6	9.2	7.9	5.4	2.4	3.7	1.6	1,768	1,532
$2,000 to $3,000	36.8	12.8	15.4	10.3	10.9	5.3	2.4	4.7	1.4	2,718	2,534
$3,000 to $4,000	34.8	11.5	15.0	10.8	13.3	5.5	2.3	5.7	1.1	3,570	3,487
$4,000 to $5,000	33.0	10.9	15.5	11.4	14.4	5.1	2.2	6.3	1.2	4,450	4,462
$5,000 to $6,000	31.9	10.3	15.4	12.3	15.5	4.8	2.2	6.3	1.4	5,257	5,449
$6,000 to $7,500	30.6	10.3	15.3	12.8	15.6	5.0	2.1	6.9	1.3	6,043	6,618
$7,500 to $10,000	30.4	9.9	15.2	13.5	15.4	5.2	2.1	6.9	1.3	7,108	8,434
$10,000 and over	25.5	10.7	20.2	14.1	12.8	4.1	1.9	7.8	2.9	10,773	15,914

[a] The term "families" includes both family units and single consumers.

Source: Adapted and computed from *Study of Consumer Expenditures, Incomes and Savings* (Philadelphia: University of Pennsylvania, 1957), Vol. 18, pp. 2–3.

Household Expenditure Patterns

The data for the economy give some idea of the market for various categories of products. The marketing executive, however, is interested in further breakdowns that will show him more specifically the detailed characteristics of his market and the factors that help to determine consumer expenditures. Several studies have been made that accomplish these purposes, at least in part. The most recent and comprehensive are the *Study of Consumer Expenditures, Incomes and Savings* of the University of Pennsylvania, based on data gathered by the Bureau of Labor Statistics as of 1950, and the *Study of Consumer Expenditures* of *Life* magazine, which is based on a sample survey made in 1956.[18] The 1950 study included only urban residents, but the *Life* study includes both urban and rural households.

Effect of Income on Expenditures. The expenditures of consumers for specific goods and services vary according to their incomes, the region and size of city in which they live, the size and composition of the family, occupation, education, and race. The most important characteristic affecting consumption is generally believed to be income, although some questions have been raised in this regard.[19] Expenditure data for 1950, classified according to income levels, are shown in Table 5-8. Although there are exceptions, which will be noted by studying the table, in general the data show that a smaller proportion of the total expenditures of higher income groups is made for food and housing and a larger proportion for clothing, transportation, and recreation. For household operation (which includes heat, utilities, furnishings, equipment, and other similar items), the lowest and the highest income groups spend the largest proportions, whereas the middle income groups do not show much variation in percentages of expenditures. It should be understood, of course, that the higher the income group the greater is the absolute amount spent for any category of goods and services.

The *Life* study of 1956, the results of which with respect to income are presented in Table 5-9, shows somewhat similar results but indicates a

[18] The basic data of the 1950 study have been compiled in 18 volumes under the general title *Study of Consumer Expenditures, Incomes and Savings* (Philadelphia: University of Pennsylvania, 1957). Earlier compilations of some of these 1950 data were reported in *Family Income, Expenditures, and Savings in 1950*, Bull. No 1097, revised (Washington, D.C.: Bureau of Labor Statistics, June 1953). A portion of the data from the *Life* study was published in four volumes and numerous other releases by Time, Inc., during 1957 and 1958. Earlier studies of considerable interest and value include *Consumer Expenditures in the United States, Estimates for 1935–36*, (Washington, D.C.: National Resources Committee, 1939), and *Family Spending and Saving in Wartime*, Bull. No. 822 (Washington, D.C.: Bureau of Labor Statistics, 1945).

[19] See Robert Ferber, "Our Changing Consumer Market," *Business Horizons*, Spring 1958, esp. pp. 55–61.

TABLE 5-9

Household Expenditure Patterns for the United States by Income Class and Type of Product, 1956

Income Class	Per Cent of Total Expenditures								Total Annual Expenditures per Household
	Food, Beverages, and Tobacco	Clothing and Accessories	Home Operation and Improvement	Home Furnishings, Equipment, and Appliances	Medical and Personal Care	Automotive	Recreation	Other [a]	
All Households	29	12	19	9	5	14	5	7	$4,110
Under $2,000	36	11	17	7	7	11	5	6	1,933
$2,000 to $3,000	33	11	20	8	5	13	5	5	2,924
$3,000 to $4,000	30	13	18	8	5	15	5	6	3,839
$4,000 to $5,000	29	12	19	8	5	14	6	7	4,363
$5,000 to $7,000	28	11	19	9	5	16	5	7	5,016
$7,000 to $10,000	26	13	18	9	5	15	5	9	6,063
$10,000 and over	24	14	18	10	6	15	6	7	7,946

[a] Includes life insurance premiums and nonmedical professional services.

Source: Adapted with permission from the Life *Study of Consumer Expenditures,* Vol. I, Time, Inc., 1957, pp. 17, 20.

greater homogeneity of spending pattern. The higher income groups spend less proportionately for food and more for home furnishings and equipment. Otherwise, the spending patterns of the high income groups, especially in comparison with middle income families, do not show substantial differences. Of course, the income groupings are somewhat different in the two studies, and careful comparisons are difficult to make. It does appear, however, that different income groups buy about the same proportion of the various goods and services, although it is obviously the case that those with lower incomes must buy lower priced products, e.g., Chevrolet automobiles rather than Cadillacs.

Effect of Other Factors on Expenditures. It is undoubtedly very difficult to separate the effects of income on consumer expenditures from the effects of other factors such as education, stage of the life cycle of the family, and place of residence. However, the *Life* study does include certain analyses which attempt to eliminate the effect of income, and the results indicate that these latter factors are of considerable importance in determining consumer spending patterns. The following represent some of the more significant conclusions: [20]

1. The better educated spend proportionately less on food and more on clothing and housing.

2. Households composed of older persons spend proportionately more on food and less on automobiles.

3. Families with children spend relatively larger amounts on food, while those with teenage children have higher expenditures for clothing than do those with younger children. Families with teenage children have the lowest relative expenditure for housing.

4. Households living in central cities spend proportionately more on clothing than do suburban dwellers.

5. Families living in metropolitan areas have relatively higher expenditures for food, clothing, and housing but lower expenditures for automobile transportation.

6. Families living in the Northeast spend proportionately more for food and clothing but less on automobiles, while those living in the West have the highest relative expenditure for automobiles but the lowest for food of any region.

[20] See Life *Study of Consumer Expenditures,* Vol. I, Time, Inc., 1957; Richard H. Ostheimer, "Who Buys What?—*Life's* Study of Consumer Expenditures," *Journal of Marketing,* January 1958, pp. 264–9; also Ostheimer, "The *Life* Study of Consumer Expenditures; Its Implications About Future Markets," in W. David Robbins, (ed.), *Successful Marketing At Home and Abroad* (Chicago: American Marketing Association, 1958), pp. 273–7.

As a result of facts such as these, it has been concluded by some who have studied the *Life* data closely that income is no longer the principal determining factor in consumer expenditure patterns. Average income has increased in recent years, as has already been noted, and moreover it has become more widely diffused. Accordingly, expenditure patterns are as likely to depend substantially upon amount of education, stage of the life cycle, place of residence, and similar factors, as upon income.

Expenditure for Specific Products. The data obtained in the two expenditure studies that have been discussed here is quite voluminous and contains a great deal of information about specific products. It is not possible to present detailed conclusions, but the following are illustrative of the type of information that is available and of interest to marketing executives: [21]

1. An unusually high proportion of the sales of drugs are made to people with incomes of less than $5,000. Presumably the reason lies partly in the fact that older people, especially those who are retired, are likely to be in the lower income groups.

2. Sporting goods, more than any other item, seem to be sold to a luxury market. The 30 per cent of the families with incomes under $3,000 incurred almost 14 per cent of total expenditures but made only 5 per cent of the purchases of sporting goods. On the other hand, 6 per cent of the families had incomes in excess of $10,000, incurred 14 per cent of total expenditures, but made 29 per cent of the purchases of sporting goods.

3. Persons residing in the southern part of the country spend more for carbonated beverages and cosmetics than do those living in other regions.

4. Persons residing in the West spend more for cameras and photography and for sporting goods but relatively less for personal insurance than do residents of other areas.

5. Low income groups purchase relatively large shares of canned soups and coffee whereas high income groups purchase relatively large shares of frozen fruits and juices.

6. Negroes spend relatively more for clothing and personal care than do members of other races.

Conclusions. Many factors influence consumer spending, and it is evident that the trends in population movement and in income distribution presented in the previous sections have had important effects upon expenditure patterns. But other factors also influence spending and it is not necessarily easy to

[21] See Irwin Friend and Irving B. Kravis, "New Light on the Consumer Market," *Harvard Business Review*, January–February 1957, pp. 110–2.

determine what the net effect of these factors will be in the future. For example, the long-run declining trend in proportional expenditures for clothing may well be reversed in the future as the larger number of families with subteenage children reach the teenage stage of the life cycle. On the other hand, the tendency of this latter group to spend more proportionately for clothing may be offset to some extent by a continuation of the population movement to the suburbs. Families at this stage of the life cycle are more likely to live in the suburbs, and suburban residents spend less for clothing than do residents of the central cities.

Actually, both of the studies cited here point out that the dominant impression obtained from the data is the growing *homogeneity of the American market.* Consumers are becoming more and more alike in their spending habits regardless of location, occupation, race, or income. During the 1930s, marketing men spoke of a lower-half market and an upper-half market. The changes in the distribution of income that have taken place since that time have resulted in a more uniform, more homogeneous market. There are still differences in markets of significance to the business executive, but more and more he must base his marketing plans on the assumption that the market for consumer goods is a universal one and that virtually every family is a potential purchaser of his product.

QUESTIONS FOR DISCUSSION

1. Forecasting is at best a hazardous occupation, but, on the basis of the information contained in this chapter and assuming a peacetime economy with normal growth, what developments would you expect between 1965 and 1975 with respect to the markets for (a) automobiles, (b) gasoline, (c) women's shoes, (d) golf clubs, (e) automatic dishwashers, and (f) power lawnmowers? Why?
2. Study the percentage figures in Table 5-7 and forecast what you think the corresponding figures will be in 1967. Explain your reasoning.
3. Engel's laws of consumption may be paraphrased somewhat as follows: that the greater the income of a family the smaller will be the *proportion* of its expenditures for food and the greater will be the *proportion* of its expenditures for sundries—education, recreation, and the like. The *proportion* of expenditures for clothing, housing, and utilities remains constant regardless of income. Do the data in Tables 5-8 and 5-9 tend to verify Engel's laws? If possible, read also the Loeb article cited below.

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6. CONSUMER BEHAVIOR AND MOTIVATION

Although the business executive must know the basic facts about the character and location of the consumer market, this should be only the beginning of his study of the consumer. He must know the reactions of consumers to his specific product, for that is what he is trying to sell. Regardless of how great may be the increase in population, income, and consumer expenditures over a period of time, there are always products for which consumer demand is declining and other products for which it is increasing. For example, between 1948 and 1958, the sale of natural soap fell by almost 60 per cent while the sale of synthetic detergents rose by about 450 per cent; canned fruit juices declined by some 30 per cent and canned fruits and vegetables increased by 30 to 40 per cent while frozen foods increased by more than 200 per cent; woolen goods were replaced in part by products made of synthetic fibers; and the sale of electric shavers, home tape recorders, food disposals, automatic coffee makers, and television receivers rose by amounts ranging from 250 to 600 per cent.[1] These changes of course are easily explained. New products are constantly being introduced into the economy, and consumers respond by buying those which fill a need or want, often reducing purchases of the older substitute products in the process. But the manufacturer of clocks might be somewhat at a loss to explain why his market declined by some 20 per cent during this same 1948–58 period.

Thus the business executive desires answers to many questions. What product or products is the consumer buying? What motivates the consumer actually to make a purchase? How does he approach the buying problem? What information does he want before making a specific decision? Why

[1] Francis L. Hirt, "Recent Experiences of Growth Products," *Survey of Current Business*, May 1959, pp. 20–5; see also "Postwar Growth in Products, Services," *Business Week*, June 27, 1959, pp. 102, 104.

does the consumer select a given brand of product in preference to another of apparently equal quality? And why at a later date does he completely reverse the process and begin to purchase the neglected item? Will the consumer be more likely to purchase the item in a supermarket or in a drug store? Why does he patronize a given retail store in preference to any one of several competitors? And many others.

There are really two problems involved in the study of consumer behavior. The first is to determine *what* that behavior is, to find out the products and brands that the consumer is actually buying. The second is concerned with the *why* of consumer behavior, why consumers do act as they do.

The first problem is definitely the easier one to solve. The firm's own sales records give some of the answers to the question of what the consumer is doing. Additional information can be obtained through consumer surveys, store audits, brand preference studies, and other types of market research.[2] At the same time, determination of what the consumer is doing is the more basic of the two problems. This fact is sometimes overlooked in our modern-day effort to answer the "why" question. Important though the latter is, the first requirement in the study of consumer behavior is to know what it is.[3]

Marketing men for many years have been attempting to understand and interpret consumer behavior, but in recent years they have greatly increased their efforts to explain why consumers act as they do and what influences behavior. Obviously a knowledge of consumer attitudes and motivations is valuable and has many uses. Advertising and sales promotional efforts can be more properly directed. Adverse consumption trends may be remedied if the cause is known. But such knowledge is useful mainly in attempting to predict what consumers will do. The prediction of consumer behavior is a most difficult problem to solve, and to accomplish it, even to a slight degree, requires as much knowledge as possible about consumer motivation. Before proceeding further with this discussion, however, it is desirable to define certain terms and to examine briefly the traditional classification of buying motives.

TYPES OF BUYING MOTIVES

In an effort to provide a framework for the analysis of consumer behavior and motivation, marketing students have attempted to distinguish between certain types of buying motives. Thus those influences which lead a consumer to choose one product in preference to another are called "product"

[2] Market research will be discussed in Chap. 24.
[3] *Cost and Profit Outlook,* January 1958, p. 1.

motives, whereas the considerations that cause him to buy at a particular retail store are called "patronage" motives. In addition, these motives have been further classified according to whether the influences and considerations are "emotional" in nature or "rational."

Product Motives

Product buying motives include all the influences and reasons that cause a consumer to purchase a given product in preference to another. "Primary" product motives are those which lead a consumer to the purchase of a general type or class of product, whereas "selective" motives determine which brand or specific item will be purchased from the general class.

At any given time, consumers are confronted with a variety of wants. A typical housewife may desire a new mechanical refrigerator, a clothes dryer, and dining room furniture. At the same time, her husband talks about buying a motor boat. Because of limitations of income, only one or two of these products can be purchased at the present time. The factors that finally cause this family to decide on the mechanical refrigerator may be designated as primary buying motives.

Once it is settled that the refrigerator is the item to be purchased, additional decisions must be made. Which brand will give the greatest satisfaction? What about the size? Which model? What is desirable in the way of special features? The answers to these questions will be determined according to the impact of various selective buying motives.

Patronage Motives

Those considerations which lead the consumer to purchase goods at a certain store are known as "patronage" buying motives. There are a great many reasons why consumers choose the retail outlets that they do. For some people, *price* is a very important factor in making this choice. Other persons may knowingly bypass the store with the lowest prices and choose an outlet that has a reputation for rendering unusually good *service* or for carrying a particular *quality of merchandise.*

Convenience of location is an important patronage motive for most merchandise and is of particular importance in the case of convenience goods for which the unit price is low and the demand for the product immediate. The single package buyer of cigarettes, for example, usually purchases from the most conveniently located dealer, regardless of the small difference in price that may exist in comparison with a more inconveniently located outlet.

The *reputation of the store* may be an important patronage motive in some instances. A women's ready-to-wear shop may have a reputation for exclusiveness and for carrying the latest fashions that will attract a certain type of clientele. Another store may carry *wide assortments* and attract shoppers on this basis.

It is very important that a retailer know something about patronage motives and, more specifically, how he can appeal to these motives to get consumers to enter his place of business. Although our knowledge of shopping behavior is somewhat limited, there are studies that indicate that the shopper tends more often than not to purchase a given item at the first store she enters. For example, Alderson and Sessions,[4] a marketing and management consulting firm in Philadelphia, found that 87 per cent of minor purchases were made after visiting only one store. Even for consumer durable goods—automobiles, refrigerators, ranges, and washing machines were the specific items studied—almost 40 per cent of all purchases involved shopping at only one store.[5] And more than two thirds of such purchases were made after visiting only two stores. Moreover, a survey of shopping attitudes conducted by the Survey Research Center of the University of Michigan indicated that less than half of the persons interviewed liked to shop around carefully and actually did so before making a purchase. Almost 40 per cent of respondents, on the other hand, indicated that they did not like to shop and that they made up their minds quickly regarding a purchase.[6]

It is thus evident that the retailer should have a great interest in patronage buying motives. He needs to know why consumers do select one store in preference to another so that he may operate his store in a way that will appeal to those motives. Once the consumer has entered his store, the retailer has a very good chance to make the sale. In addition, the manufacturer has an interest in patronage motives and an even greater interest in product motives. Since many consumers do little shopping, buying decisions favorable to a given product apparently are made in a great many instances prior to entering the place of business of the retail dealer. If the manufacturer can learn what causes the consumer to buy certain products in preference to others, he can adapt his product and his sales program to these consumer

[4] Now Alderson Associates, Inc.

[5] For automobiles the figure was 48 per cent and for washing machines 50 per cent. See Michael Halbert, "Empirical Research in Consumer Shopping and Motivation," *The Marketing Revolution*, Proceedings of the Thirty-seventh National Conference of the American Marketing Association, December 1955, p. 20.

[6] The remainder took an intermediate position. They shopped to some extent and often the amount of shopping depended upon certain factors. See George Katona and Eva Mueller, "A Study of Purchase Decisions," in Lincoln H Clark (ed.), *Consumer Behavior* (New York: New York University Press, 1954), p. 62.

desires. The product will be presold, the consumer having made his buying decision in advance of actual purchase. Shopping will be eliminated and the only remaining sales problem will be to direct the purchaser to a dealer that handles the product. However, merely classifying buying motives, as we have done here, does little to solve the problem of either the manufacturer or the retailer in determining consumer motivation. Additional information is necessary.

Emotional and Rational Motives

Marketing students, especially those interested in advertising, have formulated a number of lists of buying motives.[7] Many of these start with the basic physiological and psychological needs such as appetite, hunger, sex attraction, parental affection, and approval by others. Most of these basic drives, however, are too general in nature to explain a specific buying situation. For example, the marketing analyst can hardly explain in a meaningful way the purchase of a package of X brand of bacon on the basis solely of the consumer's general need for food. Many products will fulfill the need for food. The business executive wants to know why consumers select certain types of food in preference to others, why they prefer one brand in relation to another, and how to appeal to these specific buying motives.

Accordingly, more detailed lists of buying motives have been made in an effort to determine the specific factors affecting consumer behavior. As a general rule, these motives have been classified into two categories: emotional motives and rational motives. The distinction between emotional and rational motives applies, of course, to both the product and patronage motives discussed above. However, most classifications have emphasized this distinction with respect to product motives much more than they have with respect to patronage motives.

It is not necessary to present here a complete listing of all these influences on consumer behavior, which might run to several hundred items. The following, however, indicate the general nature of those motives usually designated as emotional:

1. Emulation, which is the tendency to imitate others and thus, for example, to buy a new car because all of the neighbors seem to have one.

[7] Pioneer work in this field was done by Melvin T. Copeland in his *Principles of Merchandising*, 1924. For a listing of Copeland's buying motives, as well as those of other writers, see Malcolm P. McNair and Harry L. Hansen, *Readings in Marketing*, 1st ed. (New York: McGraw-Hill, 1949), pp. 58–61

2. Conformity or the desire to be like others. The sale of fashion merchandise is dependent to a large degree on this desire for conformity.

3. Individuality or distinctiveness, which are the opposite of emulation and conformity. Thus some people may take pride in having an unusual house, different from any other in the community.

4. The desire for comfort. Many products are purchased primarily because of this motive; they range from lounge chairs to automatic dishwashers and air conditioners.

5. The desire for pleasure and recreation.

6. Ambition, pride, and the desire for prestige.

Rational motives, on the other hand, are usually designated as follows:

1. Economy in purchase and in operation.
2. Efficiency in operation.
3. Dependability in use and in quality.
4. Durability of the product.
5. Convenience in the use of the product or in the purchase of the product.
6. Money gain or the enhancement of earnings.

An examination of these two lists may well result in raising the question of whether the distinction between emotional and rational buying motives is either meaningful or useful. The desire for comfort is said to be emotional in origin whereas convenience is rational. Ambition is emotional while the desire for money gain is rational. These are close distinctions and it is not hard to think of numerous examples of buying behavior in which it would be very difficult to distinguish between rational and emotional motives.[8] This is particularly true since the word "emotional" is often used in a context as synonymous with "irrational."

No doubt, the purchase of a new dress, or of a fur coat, or of a new automobile, often is largely stimulated by emotional motives. But who is to say that the result did not achieve a perfectly rational goal? Who knows when the career of a young professional man may be enhanced by the fact that his wife is acceptably dressed for a social function? Or, the fact that he drives a certain make of car or belongs to a certain club may indicate to prospective clients that he is an acceptable person with whom to do business. Reasoning of this type, of course, may merely constitute the rationalization

[8] See, for example, Harry L. Hansen, *Marketing: Text, Cases, and Readings* (Homewood, Ill.: Irwin, 1956), pp. 28–31.

for an emotional action, but it serves to emphasize the fact that there is no clear distinction between the rational and the emotional. Consumer behavior cannot be so easily classified.

Nevertheless, marketing students will no doubt continue to discuss the rational aspects and the emotional aspects of consumer behavior. There is considerable controversy over the type of selling appeal that should be used for a given product under given conditions. How much attention should be paid to rational motives and how much to emotional motives? In this connection, Edward C. Bursk advances an hypothesis that deserves a great deal of consideration. He defines rational reasons for buying as those which are self-approved, that is, right and reasonable for the particular individual in a particular social situation. Irrational reasons are those which are not self-approved and socially acceptable. Thus a buyer "just feels some reasons are 'all right' for him, and others are not." [9] In this case, the important thing for the seller to remember is that he must give the buyer what he will conceive to be a rational reason for the purchase. The real reason for buying may be an irrational and unconscious one, and the buyer may desire the product very much for this reason. But the sale will not be made until the seller has advanced a reason for purchase that appeals to the buyer as a rational one.

DELIBERATION IN CONSUMER BEHAVIOR

Even if it is not possible to make definitive distinctions between rational and emotional consumer behavior, perhaps we should not be too greatly concerned. The marketing executive would be aided a great deal in his efforts to serve the consumer if he only had more specific information as to how the consumer approaches a buying situation. There is not a great deal of information on this subject, but one aspect of the problem has been studied to a greater extent than have the others. This is the degree to which the purchase decision is carefully weighed, the extent to which deliberation takes place.

In one study of supermarket shoppers, it was found that 48 per cent of all items bought were purchased without any previous plan. Twenty-nine per cent of the purchases were specifically planned and 21 per cent were planned in a general way.[10] Another study of food shoppers concluded that only 46 per cent of the purchases actually made were anticipated, the remainder being

[9] Edward C. Bursk, "Opportunities for Persuasion," *Harvard Business Review*, September–October 1958, p. 114.

[10] *Latest Facts About Today's Shopper in Supermarkets* (Wilmington: E. I. du Pont de Nemours and Company, 1954), p. 7.

classified as impulse purchases, that is, decisions made in the store.[11] A third study, this one involving Canadian consumers, found that 43.5 per cent of all food store purchases were made on impulse. Corresponding percentages for other retail outlets were 41.5 for variety stores, 33.6 for department stores, and 26.6 for drug stores.[12]

The items studied here were, of course, of the type generally designated as convenience goods and of low unit value. Perhaps we should not expect too much deliberation about their purchase. On the other hand, a study by Robert Ferber found that almost 20 per cent of the purchases of consumer durable goods—including clothing, furniture, automobiles, and appliances—were bought on impulse, impulse buying being defined in this case as purchases that were unplanned and could have been postponed.[13] Moreover, further study of the length of time of purchase plans for consumer durables indicated no plan at all for about one third of the purchases. Minor purchases were not planned in some 40 per cent of the cases; the figure for major purchases was 28 per cent.[14]

One of the more intensive studies of deliberation in the purchase of consumer durables was made by the Survey Research Center of the University of Michigan in 1953. This study concludes "that there were great differences among buyers and that many purchases were made in a state of ignorance, or at least indifference." [15] The consumer durables studied were television sets, refrigerators, washing machines, and stoves. Purchases of sport shirts were also studied to provide a product of considerable contrast. With respect to the purchases of consumer durables, less than one fourth of the buyers were rated as careful buyers. These people planned their purchases, sought information, and considered and reconsidered alternatives. "They regarded the purchase of a household good as a problem that must be solved with care." [16] Another group of buyers of about the same size exercised little or no care in their purchases. They did not deliberate about the purchase but made the decision quickly and without hesitation. They appeared to be indifferent and obtained little information. They did not seem to have the motivation to make the best possible choice. The remaining buyers were classified in

[11] James D. Shaffer, "The Influence of 'Impulse Buying' or In-The-Store Decisions on Consumers' Food Purchases," *Journal of Farm Economics*, May 1960, pp. 317–24.

[12] C. John West, "Results of Two Years of Study into Impulse Buying," *Journal of Marketing*, January 1951, p. 363.

[13] Robert Ferber, "Factors Influencing Durable Goods Purchases," in Lincoln H. Clark (ed.), *Consumer Behavior* (New York: New York University Press, 1955), Vol. II, p. 83. See also Ferber's monograph of the same title, University of Illinois Bull. No. 79.

[14] *Ibid.*, p. 81. About 45 per cent of all the unplanned purchases involved clothing.

[15] George Katona and Eva Mueller, *op.cit.*, p. 53.

[16] *Ibid.*

an intermediate group. They deliberated to some extent about the purchase but did not exercise the care of the very deliberate group. With respect to the purchases of sport shirts, even less deliberation was found than in the case of consumer durable goods.

On the basis of these studies, it may be concluded that there is often little planning and deliberation in purchase decisions. It would appear that major purchases, including high unit value items, involve more planning and deliberation than minor purchases. This is of course entirely logical. What is surprising perhaps is that major purchases are so often made with little or no deliberation. This does not necessarily mean, however, that the consumer is acting in a completely irrational manner. Wroe Alderson presents the point of view that "rationality is in limited supply and needs to be economized like any other scarce factor." [17] Rationality is thus economized by the fact that many needs can be met by standardized, branded products which are quickly identifiable in the market place.

This point of view is reinforced by George Katona as a result of the continuing studies of the Survey Research Center. He has concluded that most consumer behavior is habitual behavior, that is, that the consumer acts as he does automatically and rather inflexibly from force of habit. Impulsive buying does take place but primarily with fairly equivalent products, small purchases, or an occasional luxury, that is, in situations when it is not really important.[18] No doubt consumer behavior could be made more effective through greater deliberation and planning of purchases. But limitations of time, energy, and similar factors appear to preclude this possibility, at least for the present. It is important that the marketing executive realize these limitations and that he have as much information as possible about actual consumer behavior. He will then be in a better position to plan his marketing strategy.

THE PROBLEM OF CONSUMER MOTIVATION

The research studies cited in the preceding section have been concerned primarily with the problem of consumer behavior, i.e., what consumers do and how they act. As stated in the opening paragraphs of this chapter, such information is basic and constitutes the starting point of consumer research. The marketing executive, however, would like to know more than this. He would like to be able to predict the future actions of consumers. To do this,

[17] *Cost and Profit Outlook*, February 1953, p. 3.

[18] There is also a limited amount of problem-solving behavior involving extensive deliberation and genuine decision making. See George Katona, *The Powerful Consumer* (New York: McGraw-Hill, 1960), esp. Chaps. 9 and 14.

he needs more information on consumer motivation, that is, the "why" of consumer action.

The various classifications of buying motives do not help very much in attaining this objective. In the first place, they are more "classifications of observed behavior rather than explanations of it." [19] In the second place, as noted previously, they do not tell us which motives are really the influencing ones in a given buying situation. This latter objection can be and is being overcome in part. A compilation has been made of some 600 buying motives, as revealed in marketing research studies, which have influenced consumers at some time for some products.[20] By the use of machine tabulation the motives that have been important for a specific product, at least at some time, can be separated and listed.

Nevertheless, the answers to the "why" question are not easily obtained. We know that there is a biological basis of human behavior and that there are basic drives that must be satisfied. But we also know that there is a social basis for human behavior. Basic needs may be satisfied in many ways and with a variety of products. Exactly how these needs will be translated into specific wants depends often upon group standards and mores as well as upon individual aspirations. Many of the influences affecting consumer behavior are not understood by the individual consumer. He does not even realize that his actions are influenced by these forces. They lie in the realm of the subconscious rather than the conscious.

There has been for many years a certain amount of research on consumer motivation performed by marketing students and practitioners. Much of it has been of the type that attempts to learn about buying motives either by observing consumers in action or by asking consumers why they buy certain products, what they like about one product in comparison with another, or why they purchase at a given retail store. Undoubtedly, this research has revealed more about economic motives than it has about psychological influences, and in many cases it has failed to reveal the real motivation of the consumer. In recent years, marketing research practitioners have attempted to use the techniques of the psychologist to probe more deeply into the subconscious and to reveal buying influences that otherwise might not be uncovered. Apparently, this new form of motivation research has been used successfully in a number of instances, especially to determine why specific products have not sold well. Because of the businessman's concern with immediate operating problems, however, relatively little has been done to trans-

[19] Joseph W. Newman, "New Insight, New Progress, for Marketing," *Harvard Business Review*, November–December 1957, p. 98.

[20] The compilation has been made by C Joseph Clawson. See discussion in *Cost and Profit Outlook*, May–June 1958, p. 2.

late these scattered facts and impressions into general conclusions about consumer motivation.

It is evident that much additional work needs to be done if we are to obtain any definitive answers to the question of why consumers behave as they do. The need for research has been pointed out by numerous writers, who have also specified many of the areas of knowledge about which we need information.[21] It is not necessary here to attempt to point out all of these areas. It is sufficient to say that we must study in its entirety the subject of human wants and how these wants may be satisfied in the market place. We must study both rational and irrational behavior. We must study group influences and social mores as well as individual reactions. And we must continue to be aware of the economic forces and motives that affect the consumer.

The problems are many and complex. There are likely to be as many approaches to the subject as there are students of it. The present tendency in the study of consumer motivation is for the marketing student and the businessman to join forces with the students of the behavioral sciences, especially sociology, anthropology, and psychology. Buying and consumption are being studied as part of the general pattern of human behavior, the framework for study being supplied by the behavioral scientists. There is little doubt that this approach must be utilized if meaningful conclusions are to be obtained. At the same time a note of caution is necessary. In their enthusiasm over the potentialities of new approaches, some marketing practitioners are tending to confine their research on motivation to the sociological and psychological aspects. They have spent a great deal of time and money studying social status, ego identification, and sex imagery connected with products, but have neglected to study the motivational influence of common economic factors such as price, cost of upkeep and operation, and the like.[22] Despite frequent statements to the contrary, it should not be assumed that economic man is completely extinct.

Accordingly, a balanced research program is needed on the subject of consumer motivation, a program in which the behavioral sciences have an important but not exclusive role. A few examples may serve to illustrate the type of contribution that the behavioral sciences are making. Thus consider-

[21] See Joseph W. Newman, *op.cit.*, pp. 95–102. For a more complete exposition of Newman's position, see *Motivation Research and Marketing Management* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1957). For additional ideas and a suggested framework of analysis, see Wroe Alderson, "Major Issues in Motivation Research," in Robert L. Clewett (ed.), *Marketing's Role in Scientific Management* (Chicago: American Marketing Association, 1957), pp. 271–81. See also Pierre Martineau, "It's Time to Research the Consumer," *Harvard Business Review*, July–August 1955, pp. 46–54.

[22] See C. Joseph Clawson, *op cit.*

able study is being devoted to the way in which the members of various social groups or classes react to products and to retail stores.[23] As a result of such study, it is stated that members of the lower classes buy many things on impulse and that they want quantity rather than quality in their purchases. They also desire products that are "flashy" and that attract attention and are more interested in spending their limited incomes for automobiles and television sets than for better housing and home improvements. They tend to buy from the stores that offer the most lenient credit terms. Upper middle class people, on the other hand, desire prestige. They are more responsive to quality considerations in merchandise and prefer to shop in stores where they are known. The lower class person is intimidated by some stores whereas the upper middle class shopper feels that certain stores are beneath her. Both look for stores in which they feel comfortable.

Another group influence on consumer behavior is that exercised by friends and neighbors. Studies of the Survey Research Center have shown that more than half of the buyers of large household appliances obtained advice from acquaintances and purchased at least some of the same items as were owned by their friends. Other studies have shown an unusually high degree of ownership of particular products in certain residential areas. Not only do friends and neighbors tend to serve as sources of information and advice, but there is also a tendency for people to want to own items similar to those owned by other members of the group. "What our friends own we own too or shall own soon." [24]

Such studies as these are attempting to determine specific influences on consumer behavior. They are not concerned with efforts to classify buying motives as emotional or rational or in making value judgments regarding irrational behavior. The behavioral sciences, in fact, take "the view that an individual's behavior is purposeful and that his actions fit together consistently in his scheme of things." [25] Thus behavior which may appear to others to be irrational is actually a rational pattern for the particular individual. The research problem, of course, is to find what influences this behavior pattern. In the meantime, however, marketing executives should consider seriously Wroe Alderson's advice that in the long run the seller should look upon the consumer as a rational person engaged in problem solving. Thus "marketing opportunity consists fundamentally in helping consumers to solve

[23] The following discussion is barely suggestive of some of the conclusions reached. For more comprehensive statements, see Margaret C. Pirie, "An Anthropologist Looks at Marketing," in Frederick E. May (ed.), *Increasing Sales Efficiency*, Michigan Business Papers No. 35 (Ann Arbor: Bureau of Business Research, University of Michigan, 1959), pp. 142–62; and Pierre Martineau, "The Pattern of Social Classes," in *Marketing's Role in Scientific Management*, *op.cit.*, pp. 233–49.

[24] George Katona, *op.cit.*, p. 158.

[25] Joseph W. Newman, *op.cit.*, p. 100.

their problems rather than hoping to find a clever short cut in playing on the consumers' fears, weaknesses and suppressed desires." [26] And the consumer has many buying problems to solve, as will be seen in the next chapter.

QUESTIONS FOR DISCUSSION

1. The Survey Research Center for a number of years has interviewed samples of consumers regarding their buying intentions with respect to consumer durable goods and has then reinterviewed them to determine how well these intentions were carried out. The results on automobiles are somewhat as follows. If 20 per cent of those interviewed indicate that they plan to buy a new car within a year, about 60 per cent actually carry out this intention. Of the remaining 80 per cent of interviewees who indicate no intention to purchase, about one sixth actually do purchase within a year. Assume that, as an automobile dealer, you have made a similar survey with similar results and that you have the names and addresses of all people interviewed. How would you direct your sales efforts during the ensuing year?
2. Planned obsolescence has been defined by Gerald B. Tallman as "a purposeful program of vendors to shorten the time span or number of performances over which a product . . . continues to satisfy customers—thus presumably encouraging an early purchase for replacement." The policy of many American manufacturers of consumer durables of introducing new models each year, often it is said with little real change from the previous year, is usually regarded as one aspect of planned or forced obsolescence. George Katona states that most people purchasing new refrigerators reported that their old refrigerators were in good condition but indicated that they purchased new ones because of the new features and improvements of the latest models. A symposium on planned obsolescence at the December, 1958, meeting of the American Marketing Association brought forth such statements as the following:

   Planned obsolescence is regarded by many as economic waste.
   People want differentiation and change.
   It is the customer who has forced it on the industry.
   Isn't planned obsolescence really demanded obsolescence or planned progress?
   If new models are good annually, why not twice a year?

   Evaluate these statements and the general subject of planned obsolescence and what Edward M. Barnet calls "innovistic competition" in view of the discussion in this chapter on consumer behavior and motivation.

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7. THE CONSUMER BUYER

The ultimate result of all economic effort is to place goods and services in the hands of consumers. The basic function of the consumer buyer then is to choose which goods and services he will purchase. Decisions concerning the particular desires which shall be gratified are in the main highly personal. Choices which may result in a maximum of satisfaction to one person may be completely unsatisfactory to another. Moreover, assuming that the consumer desires to make wise choices, he cannot do so unless he knows what products are available, has both the time and ability to compare quality and price, and will take time to weigh his buying decisions.

THE PROBLEM OF CONSUMER CHOICE

The goal of the consumer in his buying efforts is to exchange his income for those goods and services which will yield the maximum satisfaction to himself and the members of his household. This really involves two broad problems: (1) how to divide his income among the various classes and types of products and services, and (2) how to obtain the most suitable items, quality and price considered, of each particular class in the time that can be reasonably devoted to their purchase. These two problems of course are closely related.

Division of Income

A proper division of expenditures among various classes of goods and among particular items in each class is obviously of the utmost importance for the attainment of maximum satisfaction. But this is perhaps not entirely a matter of free choice. For most consumers, the broad general classes of goods to be purchased are largely predetermined. The five most important

items of expense for the great majority of households are food, housing, household operation, clothing, and automobile transportation. The data analyzed in Chapter 5 indicate that, regardless of income group, over 80 per cent of family expenditures are made in these five product groups.

Although the average consumer may exercise relatively little choice as to the broad general classes of goods for which he spends the bulk of his income, he does have a wide choice of products within these classes. Even basic physical needs can be satisfied by many different products, and the development of new and improved products has changed and multiplied desires until the things people want seem to be without limit. Moreover, the myriad of specific items available from which consumer choice is made also seems to be without limit.

To choose among the alternatives that are open to him is not a simple matter for any consumer. He must eat, but shall he eat at a restaurant, and if so at which restaurant, and which of the many items on the menu? Or shall he have his dinner at home, and if so, of what shall it consist? For a vegetable, he may decide on green beans. But shall they be fresh, frozen, or canned? Housing must be provided but shall he rent or buy or build? How large shall the house be and with what features? Shall he forego a new automobile for the next few years in order to obtain a larger and more expensive house than would otherwise be possible? The answers to such questions as these depend upon a great many factors, as we have seen in the previous chapter, and the forces underlying choice are by no means fully understood.

Obtaining Suitable Products

Decisions with respect to the classes or types of products to be purchased constitute only the first step, however, in consumer choice. Many additional decisions must be made. What quality of product shall the consumer buy and what price shall he pay? Which brand, size, model, or color will be most suitable for his needs? And from what sources can the necessary information be obtained on which to base a buying decision? Obtaining the most suitable product is the major buying problem of the consumer in a modern high-level economy, because of the great variety of products that are available.

There are hundreds of brands of canned foods from which consumers may choose, all offered in various sizes of containers and at many different prices. One appliance manufacturer alone is said to have 63 basic models of appliances that can be modified in 342 ways, while another has 316 cabinet styles and models in radios, television sets, and phonographs. It is said that

one of the major automobile manufacturers has so many combinations of color, interior fabric, power, styling, and accessories in its automobiles that it could operate at full capacity for a year without producing two identical cars. Does the consumer really want so wide a choice of products or is he only likely to be confused by the great variety? The answer to the first part of the question is not easy to obtain, but it is undoubtedly true that there is a great deal of confusion in buying.

But habits are formed and decisions are made, often on the basis of a minimum of exact information and sometimes on a basis of misinformation. The judgment which the consumer exercises in making his choice of purchases ultimately determines the degree of satisfaction he will receive from the expenditure of his income. His choices may or may not be wise, but they must be made. And the final choices of consumers are important not only to individuals, but in the long run to the economy as a whole. It is out of the difficulties involved in making the most effective use of consumer incomes, and the recognition of certain apparent conflicts between the attempts of the consumer to purchase what he wants or should have and the attempts of individual businessmen to induce him to purchase their particular products, that the widespread study of consumer problems has developed.

CONSUMERS AS BUYERS

It has been pointed out previously that the ultimate consumer is neither a skilled nor a careful buyer, and that because goods used in personal consumption satisfy intangible desires, the same physical characteristics provide different degrees of satisfaction to different persons and to the same person from time to time. Moreover, new products are constantly appearing and individual incomes increase and decrease. Thus it is often necessary for the consumer to reappraise desires, develop new scales of value, and reconsider existing purchasing habits in the light of new or improved products as they become available and in the light of changes in his income.

It is obvious that the average consumer has neither the ability nor the time to make a careful personal investigation of all the purchases he makes. He must depend, therefore, upon available sources of information in order to make a selection, and the right kind of information is often lacking or difficult to interpret. No one person could accumulate enough knowledge and skill in a lifetime to become expert in the evaluation of all the products available for purchase. Even persons who have the requisite basic knowledge and skills to analyze a few of the products they use seldom find it worthwhile to do so, since the time required to make such analyses is usually out of all

proportion to the increased satisfaction or saving in costs which could result. Consumer purchases are made on a scale too small to warrant such efforts by individual purchasers. They believe that they can spend their time to better advantage in other ways. Even if consumers were to attempt to make these careful evaluations, they would soon find them to be out of date. Income, products, desires, and prices are constantly changing, and so individual evaluations of particular products must constantly change also.

The average consumer must make his buying decisions on the basis of his own examination of and previous experience with the product, supplemented by such additional information as may be available. Often the principal source of additional information is that supplied by the seller, through retail salespeople or labels or advertising. But retail salespeople commonly have little knowledge of the products they sell. They naturally hope to sell the products that are available in the store they represent, and they are frequently influenced by the proprietor or by manufacturers to "push" the sale of particular items. Finally, because of the vendors' desire to sell their products, the careful consumer feels that he must take any advice or information coming from producers and middlemen as that of interested parties to the sale.

Purchase on the basis of examination or personal experience is also often far from satisfactory. The buyer must compare the qualities of literally thousands of articles if he is to choose wisely although, of course, many brands sold somewhere in the country will not be sold in his particular community and hence need not be considered. In fact, the one retail store in which he decides to purchase may handle only one brand, or at the most but a few of the competing brands, of any given product. This may simplify his immediate problem, but it does not necessarily result in his making the *best* use of his income. To be sure he has seen all the brands in his community, he must visit many retail stores, something that is not done in making most consumer purchases.

But when the consumer has seen several products he may still be unable to judge. He may "see" ten brands of motor oil, but of what value is that to most purchasers? To see twenty packages of different tooth pastes, or ten different brands of canned peas, does not help much either. True, the labels and the prices may help him to narrow his choice to a few, but he usually can judge the *quality* of the contents only by price—often a poor criterion. Some labels are more informative than others and may help him to make a wise choice, if he takes the time to read them and if he can understand them. But normally it is very difficult for the consumer to obtain information which can be used to make the best selections in the time he is willing to

devote to his purchasing efforts. Over a period of years experience will usually give some basis for the selection of most products the consumer buys, and he makes his choices among all the commodities he might buy without too much difficulty. But whether the products he selects are actually best for his use he seldom really knows.

The very fact that so many products are available, however, gives him, in spite of his difficulties in making choices, a wide selection among desirable products; and competition among producers and middlemen assures him of continuing efforts to improve products and services and to reduce prices. But it is perfectly evident that much remains to be done to insure the consumer the best results from the use of his income; and the realization that he does not always get the most for his money, that he does not always get a fair deal, and that his own ignorance hinders wise choices, has led some consumers to demand more information and greater protection. The attempts of consumers to gain these goals, especially during the thirties and late twenties, is known as the "consumer movement."

THE CONSUMER MOVEMENT

The consumer movement has been best defined perhaps as consisting "of all the efforts, organized or unorganized, to make the consumer a wiser buyer and user of those products and services which she requires in her capacity as a consumer." [1] The activities commonly associated with the consumer movement are designed to correct certain manifestations of business effort, such as "high-pressure" selling and questionable practices, which hamper the consumer in making wise selections of merchandise, and to help the consumer to overcome shortcomings which result from his own ignorance or carelessness.

Origin of the Consumer Movement

Although there were sporadic efforts made on behalf of consumers previously, the consumer movement really dates back to the late twenties. Between 1927 and 1936, a number of books were published, and widely read, in which the authors satisfied many readers that consumers were not getting their "money's worth." [2] In 1927 a buyers' club was organized in White Plains,

[1] Werner K. Gabler, *Labeling the Consumer Movement* (Washington, D.C.: American Retail Federation, 1939), p. 14.

[2] The following were among those which were most widely read and probably exerted great influence in promoting the consumer movement: Stuart Chase and F. J. Schlink, *Your Money's Worth* (New York: Macmillan, 1927); T. Swann Harding, *The Popular*

New York, which in 1929 became Consumers' Research, Incorporated. Its purpose was to test and analyze products and to disseminate buying information to members. In 1936 Consumers Union was formed as a rival organization to Consumers' Research.

These events gave a great deal of impetus to the consumer movement, but it is a question as to whether they constituted cause or effect. Underlying the development of the consumer movement were two fundamental factors.[8]

The first was the change that was taking place in the economy during the twenties. The country was moving from an economy of scarcity to one of relative abundance, from a sellers' market to a buyers' market. The emphasis was shifting from producing to marketing. The consumer was assuming greater importance, and competition for his patronage was increasing. Thus the consumer became more aware of his importance at the same time that he was being subjected to greater selling pressure.

The second factor underlying the consumer movement was the depression of the early thirties. Consumers needed more than ever to find the "best buys" in an effort to make their incomes stretch as far as possible. Thus there grew up a demand for information. Moreover, there was increasing competition among sellers, extravagant claims, and in many cases a deterioration in the quality of merchandise. More than ever, the consumer needed information and guidance.

Development of the Consumer Movement

Group Activities. Thus the consumer movement reflected a general distrust and lack of understanding of business. Many organizations were formed to aid the consumer in one way or another. Many existing organizations adopted programs designed to render assistance. The movement spread rapidly in the women's clubs, the schools, and the churches, and buying information was disseminated through these and other organized groups. The General Federation of Women's Clubs, the American Association of University Women, the National League of Women Voters, the National Congress of Parents and Teachers, and the Federal Council of Churches of Christ in America, as well as many other similar groups, were associated to a greater

Practice of Fraud (New York: Longmans, Green, 1935); Arthur Kallet and F. J. Schlink, *100,000,000 Guinea Pigs; Dangers in Everyday Foods, Drugs and Cosmetics* (New York: Vanguard, 1933); J. B. Matthews, *Guinea Pigs No More* (New York: Covici, Friede, 1936); M. C. Phillips, *Skin Deep, the Truth about Beauty Aids—Safe and Harmful* (New York: Vanguard, 1934); James Rorty, *Our Master's Voice: Advertising* (New York: Day, 1934); and F. J. Schlink, *Eat, Drink and Be Wary* (New York: Covici, Friede, 1934).

[8] See Kenneth Dameron, "The Consumer Movement," *Harvard Business Review*, Spring 1939, pp. 275–82.

or lesser extent with the consumer movement. Even the American Medical Association and the American Dental Association were considered to have participated in the movement since they did offer suggestions to the consumer regarding the purchase of certain foods, drugs, and dentifrices.

Governmental Efforts. The federal government took cognizance of the consumer movement in several ways. One of the more constructive was to increase the number of publications giving general buying information to the consumer, instructing him in the qualities to look for when buying furniture, clothing, and similar items. How widely these were actually disseminated among consumers is impossible to state, but at least they constituted an effort to place buying information in the hands of consumers and the agencies that were attempting to educate the consumer.

Various governmental agencies established consumer divisions and advisory boards, designed to represent the consumer interest, but they were largely ineffective. The National Recovery Administration and the Agricultural Adjustment Administration had as their principal function the raising of producers' prices. The consumer interest in this activity was largely ignored despite, at times, substantial effort by the Consumers' Advisory Board of the NRA and the Consumers' Counsel of the AAA. An effort by the Consumers' Division of the National Emergency Council to establish local county councils to collect and distribute buying information appeared promising for a time, but inadequate funds and personnel soon led to disinterest and disintegration.

Business Activities. At first, business took little notice of the consumer movement. As it gained momentum, however, it became evident that some action was required. Early action tended to be mainly in the form of counter propaganda, much of it of dubious value. Later, more constructive action was taken, and there was considerable cooperation between business and various consumer organizations. In 1937 a Consumer-Retailer Relations Council was created with representatives both from retailer associations and the women's clubs. Its purpose was to increase the use of informative labeling, informative salesmanship, and informative advertising. Similar consumer relations committees were established by other business groups.

At the same time, individual businessmen joined in the efforts to assist the consumer. Although some retailers had established merchandise testing laboratories as early as 1911, renewed activity took place with respect to the testing of merchandise. New laboratories were established by some retailers and the existing ones of other firms expanded their activities. A few retailers even established consumer advisory boards. Both manufacturers and retailers, in a number of instances, increased their efforts to improve the information

contained on the labels attached to their merchandise. In 1939 and 1940, a half-dozen canners of fruits and vegetables even adopted A B C grade labeling for their products.[4]

Efforts were also made to get buying information into the hands of consumers. Two notable examples were the publication by the Household Finance Corporation and the national Better Business Bureau of numerous booklets on the buying of specific products and on money management.

Objectives of the Consumer Movement

The above brief description of the consumer movement indicates something of its confusion, its heterogeneity, and its lack of organization, as well as of its widespread impact. Obviously, there were many different objectives, as many perhaps as there were organizations involved in the movement. The more general objectives, however, can be stated as follows:

1. To protect the consumer from fraud and misrepresentation, from adulteration of products, and from the sale of harmful products.
2. To increase the use of quality standards, grades, and informative labeling.
3. To promote the use of informative and truthful advertising.
4. To educate consumers in effective buying, not only to disseminate information to them but to educate them in the use and understanding of this information.

Accomplishments of the Consumer Movement

To what extent were these objectives accomplished? It is difficult, of course, to measure concretely the accomplishments of the consumer movement, but the following observations can be made:

1. In the field of consumer protection, the Food, Drug and Cosmetic Act was passed in 1938. Although weak in some respects, it was a notable improvement over previous legislation.[5] First introduced in the Congress in 1933, this law was not passed until some sixteen consumer groups organized to lobby for its enactment.
2. As noted above, there was some increase in the use of informative

[4] The subject of grade labeling, which has aroused much controversy in the United States, is discussed at length in Chap. 25.

[5] See Chap. 30 for a more complete discussion.

labeling, grades, and quality standards by businessmen. Both manufacturers and large retailers were involved in this movement. In addition, there was passed in 1939 (effective in 1941) the Wool Products Labeling Act which requires the labeling of the fiber content of wool products.

3. There is no satisfactory method of measuring the degree to which advertising may have become more informative and truthful. It may be presumed that some improvement has taken place. The powers of the Federal Trade Commission to control false and misleading advertising were strengthened somewhat in the Wheeler-Lea Act of 1938, and the Commission has been somewhat more active in its efforts at control since the mid-thirties than it appears to have been previously.[6] In addition, businessmen have probably been more aware of the problem as a result of the consumer movement.

4. Informational materials on buying undoubtedly increased greatly in quantity and in availability. As has been noted, they came from government, from business, from professional groups, and from organizations in general. In addition, substantial progress in consumer education was made in the secondary schools, as well as in colleges and universities.

PRESENT STATUS OF CONSUMER INFORMATION AND PROTECTION

The advent of World War II and the growth of real income during the wartime and postwar period undoubtedly have done much to lessen the consumer's concern about his buying problems. It is probably logical to conclude that the consumer movement as such ended in the early forties. Nevertheless, the foundation had been laid for the continuing studv of consumer problems, and there is still a lively interest in the subject. The following discussion summarizes recent developments and the present situation.

The Rating Agencies

Consumers' Research and Consumers Union have continued to test and rate products and to make the results available to their subscribers through their regularly published bulletins. As of 1945, neither organization could boast of a circulation much in excess of 50,000. Since that time, both have grown substantially, although Consumers Union is much the larger of the two with subscribers and newsstand sales totaling some 800,000 or more. It is estimated that between 4 and 5 per cent of the nation's spending units

[6] The Wheeler-Lea Act and the activities of the Federal Trade Commission are discussed at greater length in Chap. 30.

read one or the other of the reports of these two organizations.[7] This is indeed a remarkable record in a period during which not too much publicity has been given to the consumer problem. Subscribers to these services, however, tend to be persons of above average income and education—persons who presumably do not need to economize in their buying to the extent that those in lower income groups do.

Although the rating agencies have rendered a valuable service to consumers, it may be well to note briefly that they do have limitations and that they are not a final answer to accurate buying.[8] In the first place, not all products are or can be rated. Products must be capable of being identified if rating information is to be passed on to the consumer in a meaningful way. Thus unbranded products are not likely to be tested. Even for branded products, there are so many different brands available that it is not physically and financially possible to test them all. Secondly, there is the problem of sampling. Rating agencies usually test one item, or at most only a few items, of each brand. Variations in quality are likely to exist in many instances which make the test results not entirely reliable. Finally, there is the problem of developing standards and methods of testing. We do not necessarily know what the consumer desires in a product, nor do we know exactly how to test to determine whether the product has these characteristics. Moreover, the tests must be conducted quickly in order that information may be made available to the consumer while the product is still available in the market. Thus a vacuum cleaner that may be used by the consumer for ten years must be tested for durability in a matter of weeks. It is obvious that there are many problems.

Consumer Education and Information

Organizations that were extremely active in disseminating consumer information during the height of the consumer movement appear to be much less active at the present time. There still exists, however, a substantial volume of buying information available to the consumer, both from governmental and private sources. The Bureau of Human Nutrition and Home Economics of the federal government, the Household Finance Corporation, and the Better Business Bureaus are still active in this field. Whether this information actually reaches the hands of consumers in the volume that it once did is not known, but the suspicion may be raised that it does not.

[7] Hugh W. Sargent, *Consumer-Product Rating Publications and Buying Behavior* (Urbana: Bureau of Economic and Business Research, University of Illinois, 1959), p. 64.

[8] For a more complete discussion, see Eugene R. Beem, "Consumer-Financed Testing and Rating Agencies," *Journal of Marketing*, January 1952, pp. 272–85.

On the other hand, there has been a steady and substantial growth in the more formal phases of consumer education in the secondary schools, in colleges and universities, and in adult education classes. The courses taught involve both buying problems and money management. Certainly, a great deal of buying information is disseminated in this fashion.

In general, consumer organizations do not appear to have flourished during the fifties. An effort in 1947 to organize the National Association of Consumers to unite "grass-roots" organizations apparently has not met with great success. On the other hand, the Canadian Association of Consumers, formed in the same year, is an active and successful organization.[9] It appears to have concerned itself mainly, however, with matters of business and public policy rather than with the accumulation and dissemination of buying information. Also, it is partially financed by the Canadian government.

Governmental Activities

The period of the fifties has been described as mainly a time of consolidation with respect to governmental activities involving the consumer.[10] Some new legislation of direct benefit to the consumer has been passed during this period, however. In 1951 Congress enacted the Fur Products Labeling Act to become effective in 1952. This law requires that all furs be labeled with the official name of the fur and prohibits the misbranding and false advertising of these products. Since there had previously been much confusion in the name designations used for the various furs, this law has been a very useful one to the consumer.[11] Of similar scope and benefit is the Textile Fiber Products Identification Act passed in 1958 to become effective in March 1960. This law supplemented the Wool Products Labeling Act of 1939 and requires the Federal Trade Commission to adopt rules for the labeling and advertising of all textile products. The regulations adopted should greatly assist consumers in identifying the numerous synthetic fibers that have been developed in recent years.

In addition to labeling legislation, Congress has been concerned from time to time with improvements in consumer protection. During the late forties and early fifties, there were a number of highly publicized incidents

[9] See Isabel Atkinson, "The Voice of the Consumer in Canada," *Selected Proceedings of Fifth Annual Conference*, Council on Consumer Information, Greeley, Colo., 1959, pp. 1–10; also "Canadian Consumer Has Big Voice," *Business Week*, September 29, 1956, pp. 53–8.

[10] Warren J. Bilkey, "Government and the Consumer Interest," *American Economic Review, Proceedings* issue, May 1957, p. 557.

[11] See Karen R. Gillespie, "Fur Law Changes Fur Ads," *Journal of Retailing*, Winter 1952, pp. 145–54.

in which clothing, especially sweaters, ignited and burned while being worn. Accordingly, the Flammable Fabrics Act of 1953, which became effective in 1954, was passed to prohibit the sale of wearing apparel made of highly flammable materials. Another measure of consumer protection was passed in 1958 becoming effective in 1960, a food additives law which requires the manufacturers of food products to establish the safety of chemical and other additives used in processing food products. This means that the manufacturer must now do the necessary testing, a task previously left to the Food and Drug Administration. The latter agency, of course, must still determine whether the testing by the manufacturer has been adequate to establish safety.

Despite the enactment of these measures, the decade of the fifties is not usually regarded as one of great advancement in the area of governmental assistance to the consumer. In fact, during the early part of the decade, some of the regulatory agencies of the federal government most directly concerned with the consumer were having a difficult time obtaining adequate funds with which to carry on their activities. A definite threat existed with respect to the continuance of many of their standard functions. During 1955 and 1956, however, the situation improved considerably. For example, the Food and Drug Administration received increased appropriations, the Bureau of Human Nutrition and Home Economics retained its home equipment testing program after a considerable effort had been made to eliminate it, and the Council of Economic Advisers was proposing the use of consumer advisory groups in federal agencies and the establishment of a central consumer information office.[12]

CONCLUSIONS

The purchasing problems of consumers are indeed substantial. The greatly increased number of products available in a modern economy has made effective choice difficult, and much is to be desired in the way of usable information about products. All reasonable means should be used to make the consumer a more effective buyer, but it should not necessarily be concluded that he is imposed upon as frequently as some persons allege. It seems likely that the average consumer is reasonably well satisfied with most of the products he buys, and on the whole that he obtains good values for his money. There may well be a question as to whether more information or more skilled

[12] This brief discussion of governmental activities has been confined to those of the federal government. Most states have done little in recent years to increase their services to the consumer, although there are presently some indications of a renewed interest in the subject.

purchasing on his part would enable him to add greatly to the sum total of the satisfaction he derives from the use of his income under existing conditions.

A large proportion of the goods consumers use are purchased from retailers who desire to retain their patronage, and most of these products are sold to retailers by established manufacturers and wholesalers who likewise desire to retain consumer patronage. Few firms are able to build and maintain a successful business enterprise without rendering a satisfactory service or making a satisfactory product and selling it at satisfactory prices. Yet the fact that consumers do fairly well in their purchasing does not mean that they are entirely satisfied or that efforts should not be made to improve their purchasing effectiveness. There are difficulties faced in consumer buying which can be eliminated or modified, and there are undoubtedly many business practices which can and should be eliminated.

The ultimate solution to consumers' buying problems would appear to lie in the cooperative efforts of business, government, and consumers themselves. The regulatory agencies of government can, and should, protect the consumer from the unethical fringe of business. Moreover, businessmen have as great an interest in seeing that government performs this function as do consumers, since it is as much a protection to legitimate business as it is to the consumer. Government can also make available buying information through the educational programs of its public schools and can provide assistance and coordination to both business and consumers in their efforts to meet on a common ground.

In the final analysis, however, it is necessary that business and the consumer work together in an effort to solve the problem. Business must realize that the consumer demand for information is a legitimate one and must provide this information in its advertising and on product labels. At the same time, consumers must decide what information they want and, above all, must reward with their patronage the businessman who gives it to them. If consumers ignore in the market place, as they often do, the product that is informatively and honestly advertised and labeled, they can hardly expect the businessman to take seriously their demands for more information. The problem will be solved as, and only as, consumers assume the responsibility for their own actions.

PROJECT

To illustrate the problem of the consumer buyer, it is suggested that students be organized into small groups, that they select a product and a specific retail

marketing area, and that they find out just how many brands or varieties of the product are available for sale in this area. Where appropriate, it would be desirable to compare prices, quantities, and labeling information or specifications. After this is done, an effort should be made to locate whatever additional buying information is available to assist a conscientious purchaser in making a specific decision. A discussion of the conclusions reached should conclude the project.

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PART III

THE MARKETING STRUCTURE: RETAIL DISTRIBUTION

8. THE BASIC RETAILING STRUCTURE

THE NATURE OF RETAILING

The term "retailing" originally meant to cut again, to divide into pieces. In present-day terminology the term retains this sense, but the distinguishing feature of retailing is the sale of commodities to the ultimate consumer. Thus retailing includes all forms of selling to ultimate consumers, as contrasted with wholesaling which is concerned with sales to business buyers.

The Importance of Retailing

The position of retailing in the marketing system is important and strategic. Those who sell goods at retail are, of course, in business to make a profit, but their success in conducting their business is also vital to the agencies that supply them with goods and to final consumers. From the point of view of the producer of consumer goods, the retailer is a specialist in selling; for the consumer, on the other hand, he serves as a purchasing and supply agent. Because individual retail transactions are usually small, it is normally too expensive and too troublesome for the producer to market his goods directly to the consumer, or for the consumer to buy directly from the producer. By assembling at convenient points and from numerous sources the various kinds of products that consumers demand, the retailer enables them to purchase a variety of goods in small amounts, on short notice, and with a minimum of difficulty. This constitutes the primary service of the retailer: his community looks to him to furnish it with needed goods at reasonable prices at a convenient place, and when they are wanted.

It is difficult to overemphasize the importance of retailing. The retailer's position enables him to determine the needs and requirements of consumers for the particular kinds of commodities he handles, and he often exercises a considerable influence on their purchases. It is true that the growth of

advertising has resulted in consumer acceptance of many manufacturers' and wholesalers' brands. In addition, there has been a substantial trend in recent years toward the use of self-service in certain types of retail stores. Both of these developments have tended to reduce somewhat the influence of the retailer on consumer purchases. Nevertheless, his influence in this respect is still substantial.

The task of the retailer, moreover, is becoming more and more difficult and complex. The number and variety of products that must be stocked increases constantly. More and more foods are being produced commercially rather than in the home, even to the extent of completely cooked dinners which are sold in frozen form. Of even greater significance, new products which were never made in the home are continually being introduced to the consumer market and are being sold through retail establishments. Television sets, power lawn mowers, electric shavers, and articles made of plastics, as well as great numbers of items sold in variety, drug, department, and hardware stores are among the products that have been added to retail lines in recent years. These developments have led to an increase in the number of persons engaged in retailing, as well as in the number of retail establishments and the volume of retail business. Pertinent data for the United States, excluding Alaska and Hawaii, are shown in Table 8-1 for the census years 1929, 1939, 1948, 1954, and 1958.

Retail Establishments. The data in Table 8-1 indicate that an increase took place in the number of retail establishments of approximately 20 per cent between 1929 and 1958. These data also indicate that this increase actually took place between 1929 and 1939 and that the number of retail establishments in 1958 was about the same as the number in 1939. These conclusions, however, are not entirely valid because of differences in enumeration and classification used by the Bureau of the Census in the various years. A more valid conclusion probably is that retail establishments increased in number between 1929 and 1939 by 20 per cent and between 1939 and 1958 by about 6 per cent.[1]

In any event, it is clear that the major increase in number of retailers came between 1929 and 1939, which was largely a period of depressed business conditions, and that any increase in the number of retail establishments that may have taken place in more recent years has been a minor one, considering the growth rate of the economy and the increase in population that

[1] In terms of 1939 definitions, the figures for 1948, 1954, and 1958 are understated by perhaps 100,000 establishments. In fact, the original tabulation for 1948 showed 1,769,540 establishments. This was later revised to the figure of 1,668,479 given in Table 8-1 to conform with 1954 definitions and tabulations, which, for example, excluded all establishments with sales volume of less than $2,500 and no paid employees.

TABLE 8-1

Retail Trade in the United States: Number of Establishments, Sales Volume, Number of Employees, and Proprietors, Selected Years [a]

Year	*Number of Establishments*	*Sales Volume (in thousands of dollars)*	*Paid Employees [b]*	*Proprietors*
1929	1,476,365	47,768,656	4,286,516	1,434,704
1939	1,770,355	41,444,507	4,711,552	1,613,673
1948	1,668,479	128,849,252	7,083,315	1,742,046
1954	1,721,650	169,967,748	7,124,331	1,765,752
1958	1,788,325	199,646,463	7,911,081	1,818,666

[a] Data for 1954 and 1958 are not entirely comparable with those for earlier years because of changes in methods of enumeration and compilation used in the 1954 Census. Sales volume data for 1929, 1939, 1948 and the establishments figure for 1948 have been revised to minimize noncomparability. The establishments figure for 1954 includes leased departments as separate establishments which is not true for the other years.

[b] For the week ending nearest November 15, except for the 1929 figure which is based on average employment for the year.

Sources: U.S. Census of Business: 1958, Retail Trade, U.S. Summary, 1960, p. 1–7; *U.S. Census of Business: 1954,* Vol. I, *Retail Trade,* 1957, pp. 5, 1–5, 1–7; *U.S. Census of Business: 1948,* Vol. I, *Retail Trade.* Part 1, pp. 9, 22 (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1952).

has taken place since World War II.[2] There are probably at least two explanations for this apparently inconsistent behavior. In the first place, retailing is likely to be a more attractive occupation to the average proprietor of a small store when industrial employment is difficult to obtain and wages are low than it is when business generally is operating at a full-employment level with high wages. Consequently, a large number of new retail establishments came into being during the thirties, but many of these were promptly closed as industrial employment became available during World War II. Furthermore, they were not reopened after the war. Secondly, the constantly increasing use of the automobile has given the ultimate consumer more flexibility in shopping and has reduced his reliance on the small neighborhood store. The rise of the supermarket, and the resulting elimination of many

[2] Between 1939 and 1954, the number of persons per retail establishment increased from 74 to 94. The corresponding figure for 1929 was 83. These computations use the establishments data shown in Table 8 1 and appropriate population figures. See *U.S. Census of Business: 1954,* Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 5; and Ralph S. Alexander, "The Changing Structure of Intermediate Markets and Manufacturers' Marketing Strategy," in Robert V. Mitchell (ed.), *Changing Structure and Strategy in Marketing* (Urbana: University of Illinois, 1958), p. 68.

small grocery stores, is a case in point which illustrates the effect of the automobile upon the number of retail establishments.

Sales Volume. The trend of retail sales volume has been completely different, however, from that just discussed for the number of establishments. The data in Table 8-1 show that the major increases in sales volume have taken place since World War II. These data, however, show the actual dollar figures and do not eliminate the effect of price changes. In terms of 1935–39 average prices, the physical volume of retail sales amounted in 1929 to $39.5 billion, in 1939 to $41.9 billion, in 1948 to $66.8 billion, in 1954 to $81.5 billion, and in 1958 to $90.8 billion.[3] Thus, although much of the increase in dollar sales volume that took place between 1929 and 1958 was due to price increases, there is still a gain of 130 per cent in physical volume, and this took place during a period when population increased by only some 40 per cent.[4]

Persons Engaged in Retailing. Changes in the number of persons engaged in retailing in the various years between 1929 and 1958 show a still different picture from those previously presented for establishments and for sales volume. Between 1929 and 1958, the number of paid employees increased by 85 per cent compared with 130 per cent for physical sales volume. If the figure for number of proprietors is combined with that for paid employees, the increase in persons engaged in retailing is only 70 per cent between the two dates. Thus it is obvious that the physical sales volume per person engaged in retailing increased substantially during this period—actually about 33 per cent—although not so substantially as did sales volume per establishment—which was approximately 90 per cent.[5]

In the case of persons engaged in retailing, it is interesting to note that the major increase took place between the census years 1939 and 1948 (actually the growth took place after the end of World War II). Since 1948 the amount of increase has been relatively small. A comparison of the data for establishments, sales volume, and persons engaged in retailing for 1948 and 1958—and these data are as comparable as any in Table 8-1—show that dollar sales volume increased by 55 per cent and physical sales volume by 36 per cent during the decade, but that the number of persons engaged in retailing

[3] The 1958 figure was computed by the writers. The others are from *U.S. Census of Business: 1954*, Vol. I, *op.cit.*, p. 5. The deflator used is the U.S. Department of Commerce Index of Retail Prices (1935–39 = 100).

[4] Adjusted to 1935–39 average prices, per capita sales amounted to $322 in 1929 and $506 in 1954, a gain of 57 per cent. See *U.S. Census of Business: 1954*, Vol. I, *op.cit.*, p. 5.

[5] Because of the inconsistencies in the data, the percentages given in this paragraph should be considered as approximate rather than exact, but they are sufficiently accurate to show the general picture.

rose by only 10 per cent and the number of establishments by only 6 to 7 per cent. The greater use of self-service and prepackaging in retail stores probably constitutes the principal explanation as to why such a large increase in sales volume could take place without a greater increase in retail personnel.

The Functions of Retailing

The retailer normally performs all of the marketing functions, but his fundamental service is to assemble goods for dispersion to the consumer at the latter's convenience. This usually means also at the momentary demand of the consumer. The retailer is, consequently, forced to estimate in advance what these demands will be, and must be prepared to fill them as exactly as he can. To sell successfully he must first buy successfully; and perhaps the most difficult retail function is buying, since success or failure depends in considerable degree upon the retailer's skill in performing this function. Effective buying calls for a knowledge of the needs of his customers and of the best sources of supply. He must constantly exercise judgment as to what to buy, from whom and when, and what price to pay.

Selling, likewise, is an important function of the retailer. In fact, assuming he has performed his buying functions successfully, it is evident that his ultimate success depends on his ability to sell. He comes into direct contact with the consumer and can exercise an important influence on the demand for goods and services. Both large and small dealers can utilize modern methods of selling with success. Advertising, effective display of merchandise, adequate services, an attractive and well-planned store, well-trained salesmen, attractive prices, as well as wisely selected stocks of merchandise—all are used by successful retailers.[6]

Supplementing the performance of the functions of buying and selling, but of great importance to his operations as a merchandiser, is the retailer's performance of the other functions of marketing. His operations must be financed, and he must, in many cases, extend credit to his customers. He must pay for his merchandise and meet the expenses of operating his retail establishment. If the supply house does not do so, he must arrange for transportation from the source of supply to his store; and he frequently arranges for delivery from his store to the home of the consumer.

[6] For a detailed discussion of these points, see Clare W. Barker, Ira D. Anderson, and J. D. Butterworth, *Principles of Retailing*, 3rd ed. (New York: McGraw-Hill, 1956); William R. Davidson and Paul L. Brown, *Retailing Management*, 2nd ed. (New York: Ronald, 1960); and Delbert J. Duncan and Charles F. Phillips, *Retailing Principles and Methods*, 5th ed. (Homewood, Ill.: Irwin, 1959).

With the decreasing storage space in the average home, the retailer's function of storing goods until they are wanted has become of increasing importance to the consumer. But in spite of the growing importance of this service to consumers, the amount of stock which it is necessary for the retailer to have on hand to do a given volume of business is now less than it has been in the past. This is because the superior services now rendered as a result of modern improvements in transportation and communication enable him to secure goods on short notice. He has, therefore, been able to pass the services of storage back to the wholesaler or manufacturer to a considerable extent. On the other hand, owing to the great increase in the variety of goods demanded, most retailers must carry an increasingly diverse assortment of commodities, even though a small stock of each is enough to give adequate service to consumers.

The function of grading is not usually performed by retailers, although it is necessary for them to sort out imperfect, damaged, and depreciated merchandise from time to time. The retailer, however, does render an important service in breaking down the shipments of manufacturers and wholesalers into the smaller lot sizes demanded by consumers. Most consumer goods are dispersed through wholesale channels in larger quantities than are needed by individual consumers. It is thus necessary for the retailer to sort, and sometimes to repackage, these goods into smaller units for resale.

Finally, risk arising from the ownership of goods and the necessity of selling them at a profit must be borne by the retailer. If he does not have the products his customers call for, if fashions change, for example, after he has purchased, he is in danger of losing his patronage and of having unsalable stock left on his hands. Goods may also deteriorate. Or, having made sales, he may not be able to collect his accounts. And finally he, in common with other businessmen, may be the victim of local or general economic depression.

Classification of Retail Establishments

Retail establishments may be classified in many ways. Only an outline of these various bases of classification will be presented here. Further analysis of retail structure and institutions in this and subsequent chapters will be based upon these classifications.

Type of Operation. The first method of classifying retail establishments is according to the type of operation. Four common types of operation can

be distinguished: (1) the retail store, (2) mail order selling, (3) house-to-house selling, and (4) automatic vending. The retail store is a place of business in which goods of various kinds are assembled for sale to the ultimate consumer. Since this is the predominant method of selling at retail, the use of the term "retailing" is commonly associated with this method of selling to final consumers. In mail order selling, orders are received through the mails and delivered by mail, parcel post, express, and freight. Orders are normally made from printed catalogs and other mailing pieces containing descriptions and prices of the merchandise offered. Catalogs and mailing pieces are sometimes supplemented by the use of newspaper, magazine, radio, and television advertising. House-to-house selling is distinguished by the fact that representatives of the seller canvass potential buyers at their homes or by telephone. In automatic vending, goods stocked in a vending machine are released to the purchaser on deposit of the money called for.

Location. Retail stores, as distinguished from other types of retail establishments, may be classified according to their location. They can be described as rural, small town, neighborhood, outlying and suburban shopping district, and downtown or central business shopping district. In addition, there are public markets in cities, roadside stores and stands of various types on main highways near cities, and mobile nonstore retailers such as house-to-house canvassers.

Retail stores tend to be grouped together in trading centers. The number of stores in a trading center ranges from the single general store at the rural crossroads to the multitude of stores of practically every description found in the city shopping district. In small towns the trading center is likely to include a variety of retail stores, from which most of the daily needs of the community may be satisfied. These form the center of the town. Larger towns and small cities have one main shopping center and several neighborhood centers. In the metropolitan areas there is usually one main shopping center, such as the "loop" in Chicago, smaller but often very important centers in outlying districts and suburbs, and neighborhood centers of varying importance.

Size. Retail establishments vary greatly in size. They range from the very small family-operated store with a sales volume of only a few thousand dollars per year to the very large establishment, such as R. H. Macy in New York, which occasionally does a million dollar volume in a single day at a single location. There is no convenient and ready-made system for classifying retailers by size, although certain data will be presented in the subsequent

discussion. In general, there is a tendency to refer to retail businesses as being either large scale or small scale. Department stores, supermarkets, the large mail order houses, and chain store systems are examples of large-scale retailing, whereas the family-operated independent constitutes the typical example of small-scale retailing. Obviously, there are many firms that do not fit into either of these extreme categories, and any distinction made between large-scale and small-scale retailers is a somewhat arbitrary one. Nevertheless, there are important differences in operation between the two.

Merchandise Lines. Retail establishments are also popularly classified according to the main type of merchandise handled, such as food, hardware, drug, variety, apparel, automotive, and building supplies stores. Each type can be further divided. Among food stores, for example, important subgroups are grocery stores, meat markets, fruit and vegetable markets, candy and confectionery stores, bakeries, and delicatessens. Some retail establishments handle a wide variety of product lines and are not easily classified according to the main type of merchandise handled. Department stores and other general merchandise establishments are examples in point. Special names have been given to certain types of retail establishments, such as supermarkets and discount houses, which are descriptive partly of the merchandise handled and partly of particular methods of operation.

Ownership and Control. Finally, retail establishments may be classified according to their ownership and control. From the point of view of ownership alone, retail stores can be divided into those owned by individuals, by partnerships, and by corporations. Type of ownership also distinguishes a miscellaneous group of retail stores including consumer cooperatives and state liquor stores. More useful, however, is a division based on both ownership and control. Here the principal distinction to be made is that between independent stores and chain stores. Independent stores, however, especially in the food field, have banded together into contract chains[7] in order to compete more effectively with the regular corporate chains. Thus there is a third type of ownership and control, even though it is merely a variant of the independent form. In addition, it seems desirable to include the consumer cooperative in any detailed discussion based on ownership and control, not so much because of its importance as a retail institution in the United States—since it is of very minor significance—but more because it represents a different form of marketing organization. The discussion of these four

[7] The term "contract chain" is used in preference to the more common term "voluntary chain." As used by Nystrom, it appears to be the more accurate designation, since such chains are usually based on contracts of independent stores with wholesalers or with other independent stores. See Paul H. Nystrom, *Retail Store Operation*, 4th ed. (New York: Ronald, 1937), p. 8.

variations in ownership and control of retail establishments appears in Chapter 12. In the meantime, we shall return to the other bases of classification outlined in this section and discuss them at greater length.

TYPES OF RETAIL OPERATION

There are four principal types of retail operation: (1) retail stores, (2) mail order houses, (3) house-to-house, or direct selling, organizations, and (4) automatic vending operators. Of these four, as will be noted from the data in Table 8-2, the retail store is predominant. In 1958 retail stores constituted more than 95 per cent of all retail establishments, obtained over 97 per cent of total sales volume, and employed more than 97 per cent of all retail personnel. Mail order selling is the least important type of operation from the standpoint of number of establishments. However, these establishments tend to be operated on a considerably larger scale than is true of either direct selling organizations or vending machine operators. The result is that mail order selling is of much greater relative importance with respect to sales volume and number of employees than it is with respect to number of establishments. In all three aspects, however, it ranks below house-to-house selling. Automatic vending is the least important type of operation with respect to sales volume and number of employees.

TABLE 8-2

Retail Establishments by Type of Operation: Number of Establishments, Sales Volume, and Number of Employees, United States, 1958

	Establishments		*Sales Volume*		*Employees*	
Type of Operation	*Number*	*Per Cent of Total*	*Amount (in thousands of dollars)*	*Per Cent of Total*	*Number*	*Per Cent of Total*
Retail Stores	1,713,646	95.8	194,245,150	97.3	7,687,383	97.3
Mail Order Houses	2,550	0.1	1,986,168	1.0	98,206	1.1
Direct Selling Organizations	63,977	3.6	2,573,622	1.3	105,562	1.3
Vending Machine Operators	8,152	0.5	841,523	0.4	19,930	0.3
Total	1,788,325	100.0	199,646,463	100.0	7,911,081	100.0

Source: U.S. Census of Business: 1958, Retail Trade, U.S. Summary (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1960), pp. 1–9, 1–10. Percentages computed by the writers.

Retail Stores

It is not difficult to see why retail stores dominate the retail field. They have many advantages over the other types of operation. They are conveniently located and readily available to the consumer. Merchandise can be purchased promptly and on short notice as the consumer needs it. The merchandise can be inspected by the buyer. In many cases it can be fitted and adapted to his particular needs. Services of various types are usually rendered by retail stores, services which either are not available from other types of operation or are available only at some inconvenience to the consumer.

For these and many other reasons, the retail store is the dominant type of operation. Further analysis of the various types of retail stores and of their relative advantages and disadvantages will be made in subsequent chapters. Before undertaking that analysis, however, it is desirable to consider the other three types of operation, which under certain circumstances and for certain types of products do have an important place in the retailing structure.

Mail Order Retailing

Many types of firms sell by mail. Ordinary retail stores, especially department stores, may have a policy of accepting mail orders, and many of our larger retail institutions have special mail order departments and actively solicit such orders. Many manufacturers and some wholesalers make at least some retail sales by mail. We shall not be concerned here, however, with mail order activities which are carried on merely as adjuncts to the main selling operation. Our interest is in the retail establishment which has as its primary method of operation the receipt of orders through the mail and the delivery of merchandise by means of parcel post, express, and freight.

Importance of the Mail Order House. The great mail order house is a unique American institution. Although business has been done at retail through the mails perhaps since the establishment of the postal service, this particular development dates only from the establishment of Montgomery Ward and Company in 1872.[8] Two major types of large mail order houses have developed. One carries a great variety of merchandise of all kinds, while the other handles more restricted lines but in wide assortments. Sears, Roebuck

[8] Melvin T. Copeland [in *The Cotton Manufacturing Industry of the United States*, Harvard Economic Studies, Vol. VIII (Cambridge: Harvard University Press, 1912)], speaking of the cloth merchants of the nineteenth century, states (p. 194) that "they had agents in various cities to whom they consigned goods, and they also solicited orders by post through advertisements in the newspapers of the different cities." Although such sales were probably at wholesale, it shows that the method is not new.

and Company and Montgomery Ward and Company carry the widest lines, followed by such firms as Spiegel and Aldens with more restricted but nevertheless very wide lines. There are also numerous firms specializing in the distribution of particular products by mail. Most of these, however, are small.

The 1958 Census of Business enumerated 2,550 mail order establishments with total sales volume of almost $2 billion. Actually most mail order volume is obtained by a small percentage of the establishments. For example, the 1958 census data indicated that the 40 largest establishments—those with a sales volume of $5,000,000 or more—did 83 per cent of the total volume of business. Thus it is evident that there are many small establishments in the mail order field but that the industry is dominated by the large houses which are the subject of the present discussion. The two largest firms—Sears, Roebuck and Montgomery Ward, which together operate some 20 houses—probably account for 60 to 70 per cent of total volume.[9]

TABLE 8-3

Mail Order Houses: Number of Establishments and Sales Volume, United States, Selected Years

		Sales Volume	
Year	*Number of Establishments*	*Amount (in thousands of dollars)*	*Per Cent of Total Retail Sales Volume*
1929	271	515,237	1.0
1939	434	537,413	1.3
1948	880	1,485,352	1.1
1954	2,019	1,604,939	0.9
1958	2,550	1,986,168	1.0

Sources: *U.S. Census of Business: 1939*, Vol. I, *Retail Trade*, Part 1, p. 12; *U.S. Census of Business: 1948*, Vol. I, *Retail Trade*, Part 1, p. 20; *U.S. Census of Business: 1954*, Vol. I, *Retail Trade*, p. 1–6; *U.S. Census of Business: 1958*, *Retail Trade*, Preliminary Area Report, p. 5. All sources are from the U.S. Department of Commerce, Bureau of the Census, Washington. Percentages computed by the writers.

Changes in Importance. The data in Table 8-3 show the changes that have taken place in retailing by mail order houses since 1929. The increase in number of establishments between 1929 and 1958, on the face of it,

[9] See sales estimates of G. J. Cullinan, "Current Trends in Catalog Selling," in John W. Wingate and Arnold Corbin (eds.), *Changing Patterns in Retailing* (Homewood, Ill.: Irwin, 1956), p. 103. The retail stores of Sears, Roebuck account for 78 per cent of its total volume, which was a little over $4 billion in 1959, leaving 22 per cent in catalog sales. The catalog sales percentage for Montgomery Ward is probably somewhat higher. See *Business Week*, January 4, 1958, p. 83.

appears to be astounding. There seems to be little doubt that a large increase has taken place, although it is probably considerably overstated by the figures shown. Improved methods of canvassing, especially those used by the Census in 1954 and 1958, have resulted in locating many small businesses not previously enumerated. Nevertheless, such large and consistent increases in the number of establishments must have some basis in fact. The increases are difficult to explain, especially in view of the fact that the relationship of mail order sales volume to total retail sales has not changed greatly during the period.

The American conditions that originally favored the development of mail order selling have been summarized by Nystrom, and include the following: [10] (1) the former isolation of farm life in America, (2) high literacy and wide circulation of periodicals, (3) increased earning power and rising standard of living of the people, (4) inadequacy and unpreparedness of local retailers, (5) lower prices, (6) convenience of the mail order method, (7) unconditional guarantee of satisfaction or money refunded, (8) a reputation for truthful advertising, (9) improvement of the post office system including the establishment of parcel post, (10) rapid service in sending out orders, and (11) effective merchandising.

These conditions began to change during the twenties and have continued to change since that time. The farm population has declined and those who have remained on the farm are no longer isolated. The common use of the automobile has brought practically every person in the nation within a few hours' drive of a good shopping center, and the increased earning power and higher levels of living which are widespread make it possible for many people to forego any savings which might result from mail order buying. Moreover, the establishment of chain store units in small communities and the increased efficiency of local independent retailers have resulted in more effective competition for the large mail order houses than formerly prevailed.

Mail order volume recovered somewhat in relative importance during the latter part of the thirties. In 1958, however, it appeared to be again in about the same relative position as in 1929. Conditions such as those described above seem to indicate that mail order selling is not likely to increase in importance despite the substantial increases in establishments shown by the Census. Nevertheless, the mail order house is of considerable interest as a retail institution, and some further discussion of its methods of operation is warranted.

[10] Paul H. Nystrom, *Economics of Retailing* (New York: Ronald, 1930), Vol. I, pp. 190–9.

Mail Order Methods. Many of the methods of the large mail order house are similar to those used by other large retail organizations.[11] Thus, in the larger houses, departmentization is carried out to a high degree, and highly systematized methods of filling orders have been developed. Orders can be assembled, packed, and shipped with a minimum of cost and a maximum of speed. In order to afford better service to their widely scattered customers, and at the same time lower transportation costs for delivering merchandise to them, the large mail order houses have established branches at strategic geographical locations in the United States.

The Mail Order Catalog. Unlike the regular retail store, which must draw customers to its place of business and depend upon display, extra services, advertising, and personal salesmanship to create demand, mail order houses depend primarily upon their catalogs to create demand. The larger companies issue catalogs that range from a few hundred pages to more than 1,500. Sears, Roebuck and Montgomery Ward catalogs are now issued twice a year, and are sent to regular customers and to others on request. They are often supplemented by smaller catalogs which are used to announce special sales. The cost of the larger catalogs is substantial and the work of issuing them is most difficult. Copy must be prepared months in advance, and prices must be determined before the catalog can be printed. The pricing problem is especially acute during periods of rapid price changes.

Cash and Instalment Sales. Another feature which from the beginning has been an almost universal characteristic of the mail order business is the sale of goods for cash. But with the addition of many high-priced items and the increased use of instalment credit by many competing retail stores, it became necessary to offer instalment terms on high-cost merchandise. At the present time, complete credit service is usually available from the major mail order houses, including 30-day charge accounts, revolving credit terms, and instalment payments for any order except that an initial order must currently amount to $20 in the case of Sears, Roebuck and Montgomery Ward. Unique among mail order houses, Spiegel has solicited business exclusively on an instalment basis. A small volume of sales has been made for cash, but the bulk of its business has been on the instalment basis with no down payments required. The introduction of instalment selling has not only facilitated the sale of high-cost merchandise but has had a tendency to induce purchasers of less costly items to increase the size of their orders in order to reach the minimum credit-order size established by the various companies.

[11] For an interesting and illuminating discussion of the mail order business, see Boris Emmet and John E. Jeuck, *Catalogues and Counters: A History of Sears, Roebuck and Company* (Chicago: University of Chicago Press, 1950).

Order and Telephone Offices. With the decline in importance of the farm population, mail order houses sought methods of attracting urban consumers. Even prior to World War II, the large houses had established urban order offices and had located mail order desks in their own retail stores. Since World War II, they have expanded the use of these order offices substantially, and recently have even located them in supermarkets operated by food chains. Telephone offices have also been established. In some large cities, the consumer can order by telephone and the merchandise will be delivered the following day by truck. It is estimated that more than 40 per cent of all mail order volume is now done through order offices, order desks, and telephone offices.[12] Since shipments are made in bulk to the order offices, with a resulting saving in transportation costs, and since telephone orders are usually delivered by truck, it is obvious that much of this business does not involve in any way the use of the mails. Thus the term "catalog selling" is sometimes used in preference to the older and more established term "mail order selling."

Advantages of Mail Order Retailing. The large mail order houses possess certain advantages in relation to other retailing institutions. The great variety of merchandise which they handle, exceeding by far that of most of their nearest competitors—the large department stores—enables the two largest companies to appeal to persons in all sections of the country. Goods of all descriptions to fit widely diversified needs can be obtained on relatively short notice from the home plant or nearest branch of the mail order organization. The middle-sized firms, some of which can be compared to some extent with women's specialty stores, carry more items than many department stores and large specialty stores and have similar advantages in their more limited lines.

In addition to its universal appeal, the mail order house through its elaborate catalogs affords the entire family the convenience of shopping for goods while in the home. The complete descriptions of the merchandise offered for sale, the attractive illustrations of needed commodities, and the extensive assortments from which to choose appeal strongly to the entire household. The catalog is available for immediate reference and can be perused at leisure. Few people are willing to take the time during business hours to go over the entire stock of the retailer's store, and few retailers would allow them to do so, but the goods of the mail order houses are always at hand through their catalogs for what approximates just such inspection. The larger houses, moreover, have made great strides in improving the appearance and convenience of their catalogs. As a result of improved printing processes, they have been able to include hundreds of pages of colored illustrations. A

[12] G. J. Cullinan, *op.cit.*, p. 105. More than 1,000 order offices are maintained by the larger houses in addition to order desks in retail stores and telephone offices.

large proportion of the remaining illustrations are in rotogravure, and descriptions of new merchandise and price changes can be added a few days before the time of publication. This change has enabled them to carry fashion lines much more effectively and to add up-to-date novelty items at a much later time than was formerly possible.

An important factor in the success of the better houses is their reputation for integrity, and the confidence on the part of their customers that goods purchased will be as represented or the purchase price will be refunded. This advantage is not confined to the mail order business, but because of the distance of customers from the house and the fact that cash is frequently sent with orders, it is undoubtedly an essential element in creating and retaining business. Many a customer has been kept, and many a new one made, through the policy of allowing goods to be returned at the expense of the firm and refunding the purchase price of the article without question. This guarantee of complete satisfaction to the buyer has been one of the chief factors upon which the success of mail order selling has been built.

In spite of the appeals to other buying motives, price remains a major selling argument of the large mail order establishments. That they sell some articles at lower prices than do competing retail organizations is undoubtedly true; that most of their sales are made on this basis is not so evident, particularly when the cost of delivery, usually paid by the customer, is considered. But that they compete successfully by using a price appeal can hardly be questioned.

Mail order houses have certain cost advantages in relation to retail stores in that they dispense with many of the more expensive selling services. They do not require high-rent locations, expensive selling fixtures, or sales personnel. On the other hand, the expenses involved in issuing catalogs and in filling orders are substantial. It is usually assumed that mail order houses have somewhat lower operating costs than do the retail stores which constitute their greatest competition, but there is little specific information on the subject. Actually, because of the integrated nature of their operations, it is difficult to compare costs of operation of mail order houses with those of competing retailers who buy through the ordinary wholesale channels, or even with chain store competitors, because chains do not carry as complete lines or integrate in a completely parallel way. In common with other large retail organizations, however, the large mail order houses do have buying advantages which make it possible for them to sell on a price basis.

Disadvantages of Mail Order Retailing. The greatest disadvantages under which the mail order house operates arise out of the distance that separates the house and its customers. This makes it necessary for the purchaser to

wait some time before his order is received, and so handicaps the sale of products consumers wish to have as soon as the desire is felt. Most consumers do not plan their purchases of products for current use very far in advance of the time they consume them. It follows that orders for such commodities may not be mailed in time for deliveries to be made before the products are needed. Moreover, the distance of the average purchaser from the mail order house necessitates the payment of transportation costs, which add considerably to the total price paid and so tend to offset the price appeal of the catalog. Deliveries, moreover, are necessarily slow, compared to the convenient and immediate delivery from the retail store. Not only is delivery slow, but repacking and shipping goods which the purchaser desires to return is a chore not commonly relished.

Another great handicap in selling goods by mail is the lack of personal relations. The merchandise the mail order house sells is effectively described in its catalog and an attempt is made to foresee all of the questions that will arise in the mind of the prospective customer, but a catalog cannot be a complete substitute for a good salesman. It cannot meet unforeseen objections, nor can it give the customer personal advice and assurance that the article in question will meet his particular needs. Moreover, the buyer does not see the goods before purchase, an especially significant disadvantage in the sale of clothing, furniture, and other products for which style and design are important. No matter how generous a concern may be with its guarantees of satisfaction, many customers do not like to bother with returning goods or to find, after waiting several days for goods, that they are not what was wanted or that a part of the order was not filled. The best houses, through the excellent descriptions of their goods, have gone far in eliminating these difficulties. But there are many articles which are difficult to describe accurately, and even with the best of descriptions and of intentions the purchaser may be led astray or left in an uncertain state of mind. There are also disadvantages in buying some large items, particularly mechanical and electrical devices such as television sets and sewing machines. For no matter how generous the mail order company's adjustment policy, if such articles prove to be unsatisfactory or defects develop, the customer finds it troublesome to secure proper servicing and adjustments.

Finally, there are disadvantages with respect to the time lags involved in the basic nature of mail order operations. These apply particularly to changes in fashion and in price, and the mail order house must assume a somewhat greater degree of risk than does the ordinary retail store. By judicious buying, retail stores are able to buy style goods and sell them before there is time for fashions to change. But the mail order house must make its purchases,

have the descriptions and engravings made for its catalog, and have the catalog printed and distributed before making a single sale. Thus several months sometimes intervene between the purchase and sale of goods. In the meantime, fashions may have so changed that there is no demand for the merchandise. In times of rapidly changing prices, the fact that the prices published in the catalog will prevail until another is published may cause considerable difficulty. When prices are rising, orders increase and many orders will be filled from stocks that may have to be purchased at a higher cost than was anticipated when the goods were priced. This will be true unless an adequate supply was purchased or contracted for at lower prices, or unless the order for the higher-cost goods is not filled. When prices are falling rapidly, the catalog prices are often higher than are those in competing stores, and volume suffers.

Conclusions. Large-scale mail order retailing came into existence to serve the rural population of the United States. For many years, it was closely tied to one class of customer—the farmer. As the farm population declined relative to the urban population and as the automobile relieved the isolation of the farmer, mail order retailing also declined in relation to the retail store. Mail order houses have adapted their operations to these social changes and now direct much of their promotional effort to urban consumers. For many such persons, order and telephone offices—as well as the direct mail order from the catalog—represent a convenience in shopping that is not available in the crowded retail stores located in congested shopping areas.

There is little evidence, however, to indicate that mail order retailing will make a major comeback. Despite what appears to be a significant increase in numbers of establishments since 1929, sales volume relative to total retail sales has remained constant since that time. There is no reason to believe that this trend will change, a fact recognized by the two large mail order firms during the late twenties when they began to establish retail stores. Since that time, both Sears, Roebuck and Company and Montgomery Ward and Company have devoted their principal efforts to the expansion of their chains of retail stores. In more recent years, other firms—for example, Spiegel in 1946—have followed suit.

The mail order house is sufficiently well established as a retail institution that it will continue to exist, probably with about the same degree of relative importance that it now has. The larger operations have sizable investments in consumer acceptance, as well as in fixed assets, which will not be readily liquidated. But the development of low-cost types of retail stores—the chain store, the supermarket, and the discount house—has brought greater price competition into retailing and has reduced the effectiveness of the major

sales appeal of the mail order house, namely, that it could sell merchandise at lower prices than could competing retail stores.

House-to-House Retailing

House-to-house selling is one of the oldest forms of retailing, the name "peddler" being applied to those persons who engaged in the practice in medieval Europe and colonial America. The method differs from other types of operation in that the entire initiative is taken by the seller. No retail store is maintained; the articles offered for sale, or samples, are brought to the home of the prospective purchaser. In some cases the entire transaction is completed at once, whereas in others orders are taken and the goods delivered later, either by the salesman or by mail or express. In such cases a small deposit is usually paid by the buyer, this amount often representing the remuneration of the salesman, and the remainder of the sales price is normally paid upon the arrival of the merchandise.

Importance of House-to-House Retailing. In 1958 the Census of Business enumerated 63,977 establishments of direct selling organizations with a sales volume of more than $2.5 billion, or 1.3 per cent of all retail sales. This latter figure represents the same percentage of total sales volume as existed in 1954, despite a decline in number of establishments between the two years of almost 10 per cent. Census enumerations prior to 1954 were made in such a way that many small home-operated organizations were not located, and it is not possible to make accurate comparisons with previous years.[13] Probably there has been some increase in the relative importance of house-to-house retailing since 1929,[14] but it is still a minor factor in total retail trade. It should be noted, however, that the census figures do not include house-to-house sales made by the outside salesmen of retail stores, nor do they include such sales of manufacturers or wholesalers who do not maintain separate sales headquarters.

For some products, house-to-house retailing is an important method of distribution.[15] Most encyclopedias and other reference books are sold in this

[13] For example, in 1948 only 3,451 establishments were located. These establishments did 0.5 per cent of total retail volume. *U.S. Census of Business: 1948*, Vol. I, *Retail Trade*, Part 1 (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1952), p. 20.

[14] There is little doubt that a significant increase in direct selling took place during the depression years of the thirties. In 1933 such organizations accounted for 0.7 per cent of total retail sales compared with 0.2 per cent in 1929 and 0.4 per cent in 1939. See *U.S. Census of Business: 1939*, Vol. I, *Retail Trade*, Part 1 (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1943), pp. 11, 30.

[15] See Victor P. Buell, "Door-to-Door Selling," *Harvard Business Review*, May–June 1954, pp. 113–23.

way. A considerable volume of household goods are sold door-to-door by Stanley Home Products, Fuller Brush Company, Tupperware Home Parties, and other firms. Electrolux in vacuum cleaners and Avon Products in cosmetics are leading firms that use house-to-house methods exclusively. According to census data, almost one half of the total sales of direct selling organizations is obtained in food products.[16] Not only are milk and bread route companies of some importance in this field, but there also exist several packaged food specialty houses that operate through truck route salesmen. Jewel Tea Company and Grand Union are the best known of the latter type, although both now obtain the bulk of their sales from their retail stores.[17]

Advantages of House-to-House Retailing. The principal reason for door-to-door selling is that it permits an aggressive sales effort and thereby results in a larger sales volume than the seller would otherwise obtain. The salesman does not wait for the consumer to make the initial contact; rather he calls on the consumer and attempts to create a desire for his product. Obviously, many of the salesman's calls are unproductive. On the other hand, he does succeed in attracting the consumer's interest in a sufficient number of cases to make this type of selling profitable. And in these cases, he usually has the full attention of the buyer for a period of time without serious interruption and without the presence of competing merchandise to distract the buyer's attention. Under these conditions, a skillful and well-trained salesman can achieve a high sales volume. And the interests of the consumer are not necessarily poorly served by this arrangement. One of the frequent criticisms of retail store salespeople is their lack of merchandise knowledge and the poor selling service that they give. Certainly, the house-to-house salesmen of the reputable firms are much superior to the average retail store salesperson in these respects.

From the viewpoint of the consumer, there may be a certain amount of convenience in buying from house-to-house salesmen. Purchases are made with a minimum of effort and do not have to be carried home by the buyer as is sometimes the case with purchases made at retail stores. Modern-day problems of traffic congestion and lack of parking space have worked in favor of direct sellers who provide regular neighborhood delivery service. On the other hand, purchasing from door-to-door salesmen is not basically a con-

[16] Obviously, house-to-house sales of food products are a negligible proportion of total retail food sales. For a breakdown of house-to-house sales by product groups, see *U.S. Census of Business: 1954*, Vol. I, *op.cit.*, p. 1–6.

[17] Jewel Tea entered the retail store field in 1932. By 1956 its retail stores accounted for 77 per cent of its retail volume. For an interesting account of the company's operations, see John S. Wright, "A Brief Marketing History of the Jewel Tea Company," *Journal of Marketing*, April 1958, pp. 367–76.

venient method of buying if done on a large scale. Too much time would have to be spent in selecting the desired products from the many available. So long as only a few products are sold in this way, it may be more convenient for some consumers to buy them in this way than to obtain them at a retail store. If the selection of merchandise available on a house-to-house basis were to be greatly enlarged, and the number of different salesmen visiting the home were thereby greatly increased, this advantage of convenience would disappear rapidly.

Finally, house-to-house selling is a flexible method of retailing. There is no fixed investment in a retail store with a specific location. As population moves from one area to another, the house-to-house salesman can easily follow it while the retail store must dispose of existing facilities, perhaps at a loss, and obtain new ones. House-to-house selling organizations also have greater flexibility with respect to costs. There is a minimum of overhead and the sales force is usually paid on a straight commission basis. If sales volume declines, expenses are more likely to decline proportionally than would be the case for the retail store, which has a higher ratio of relatively fixed costs.

Disadvantages of House-to-House Retailing. One of the principal difficulties encountered by house-to-house salesmen is a certain amount of consumer skepticism and even distrust. Many people dislike being bothered and having their work interrupted by the salesman's call. Others have a fear of fraudulent schemes or are afraid that they will contract to buy something which they will later decide they do not want. The result is that many of the salesman's calls are unproductive. Even when the salesman gains access to the household, the time required to make a sale is likely to be greater than is true of a retail store sale because in the latter case the buyer often has been presold on the merchandise. In order to save selling time, some direct selling firms now have salesmen make two calls. On the first visit, the salesman leaves a catalog; a few days later he returns and takes the order.

Probably the greatest management problem faced by house-to-house organizations is that of recruiting and training sales personnel. The problem is an especially difficult one in prosperous times when employment is easy to obtain. Turnover rates of as much as 300 per cent per year are not uncommon.[18] Obviously, the expense of recruitment and training is substantial, not to mention the loss of sales volume that results from replacing experienced persons with inexperienced ones and the disruptions in territorial coverage

[18] Victor P. Buell, *op.cit.*, p. 117. In eleven months of 1956, the Fuller Brush Company hired 15,377 men and lost 15,382. See "Fuller's Twist on Door-to-Door," *Business Week*, December 8, 1956, pp. 52 ff.

that take place when shifts in personnel are being made. Most house-to-house firms claim to be continually understaffed anyway. In an effort to solve these manpower problems, some firms employ a great many women on a part-time basis, although turnover of this type of personnel is substantial also.

House-to-house retailing is basically a high-cost method of distribution. Although most consumers probably do not realize this, there undoubtedly is some resistance to the high prices that often result from these high costs. There are several reasons for this cost situation. In the first place, selling costs are high, and commission rates paid to salesmen (up to 40 per cent) often equal or exceed the total markup obtained by retail stores. In addition, field managers are usually necessary and this is an added expense. In many firms, they are paid a commission on the sales of each salesman they supervise. There is a substantial amount of record-keeping expense, both with respect to personnel and with respect to orders and shipments. Orders are handled and shipped in small quantities, no doubt at a higher cost per unit than would be incurred if quantities were large. In some cases, these high costs of making contact with each individual consumer may be offset by the fact that a larger volume is sold, but it seems doubtful that this is generally true. Therefore, the high cost of distribution is usually considered to be a major disadvantage of house-to-house retailing.

Finally, door-to-door selling has been hampered in some communities by municipal legislation. The most drastic law of this type is the so-called "Green River" ordinance which makes it illegal to solicit business at a home except at the specific invitation of the householder. Other municipal laws provide for the licensing of house-to-house salesmen, and fees of varying amounts are charged for these licenses. Although the Green River type of ordinance has been used since the early thirties,[10] its constitutionality was not finally established until 1951 when the U.S. Supreme Court refused to review a lower court decision holding it constitutional. The effect of this decision on house-to-house selling has not been so great as might be expected. Most of the communities that have enacted restrictive laws are small ones, and the total effect has not been substantial. Moreover, the industry has been alert to the problem and has been active in meeting local pressures for such laws with counterpressures and educational measures.

Conclusions. Although a number of the leading business firms of the country have used house-to-house selling very successfully, it is not likely to become a major factor in our system of retail distribution. The difficulties involved in obtaining personnel and the fact that it is a high-cost method of

[10] The first such ordinance was passed in Green River, Wyoming, in 1931.

distribution are sufficient reasons to warrant the belief that its growth will be limited. It is clearly impossible to obtain the human and other resources necessary to make direct contact with millions of households for the purpose of selling on a large scale the great variety of products now purchased by the average consumer. It is evident that punitive legislation is, on the whole, a minor irritant. More fundamental economic factors are present to limit the development of house-to-house retailing.

Automatic Vending

Automatic vending is a form of retail selling in which merchandise is dispensed by means of a machine upon the insertion of coins by the customer. The transaction is thus completed without the aid of a salesperson. Automatic vending dates back to the early 1800s in Europe and was introduced into the United States during the 1880s.[20] Early machines were mechanically unreliable, however, and for a period of years sales were limited to penny items. In 1926 a workable cigarette vending machine was introduced, an accomplishment which has since led to the development of an ever greater variety of machines selling various types of merchandise. The growth of automatic vending has been especially pronounced since World War II.

Importance of Automatic Vending. The first effort of the Census of Business to collect information on the sales of automatic vending machine operators took place in 1948 when a total volume of $200 million was reported.[21] In 1954 there were 5,715 establishments of merchandise vending machine operators with total sales volume of $636 million. The 1958 figures show 8,152 establishments and $842 million in sales volume. In both 1954 and 1958, the proportion of total retail sales volume obtained by vending machine operators amounted only to 0.4 per cent. Thus automatic vending appears to be the least important type of retail operation. Trade estimates, however, place vending machine sales at more than twice the level of census figures.[22] The discrepancy is accounted for, in part at least, by the fact that the Bureau of the Census does not include receipts of machines owned and operated by manufacturers or wholesalers, such as soft drink bottling companies and tobacco jobbers, nor does it include receipts of machines owned

[20] Martin V. Marshall, *Automatic Merchandising* (Boston: Graduate School of Business Administration, Harvard University, 1954), p. 5. See also Dorothy S. Washburn, "The Evolution of Automatic Merchandising in the United States," in J. H. Westing (ed.), *Readings in Marketing* (Englewood Cliffs, N.J.: Prentice-Hall, 1953), pp. 94–8.

[21] *U.S. Census of Business: 1948*, Vol. I, *Retail Trade*, *op.cit.*, p. 20.

[22] Sales for 1959 were estimated at $2.2 billion, compared with $600 million in 1946. See *Business Week*, January 16, 1960, p. 76.

and operated by the establishments in which the machines are located. The census data thus include only the receipts of independent operators.[23]

Vending machines are used most widely in the sale of cigarettes, candy, and beverages. It is estimated that more than 15 per cent of all cigarettes, 20 per cent of candy bars, and 25 per cent of carbonated beverages are sold through vending machines.[24] These products, plus ice cream, milk, and coffee, are the common items sold through automatic machines. There are, however, many products that have been, or are being, distributed in this manner including ice, books, aspirin, postage stamps, razor blades, hosiery, newspapers, and many different food items.[25] Automatic machines are also widely used for in-plant feeding and this is regarded by many as a promising field for future development.[26] Experiments are constantly being carried on by retailers to determine which products can and which cannot be sold successfully by automatic means.[27] It is thus evident that automatic vending is an important method of retailing for some products. It has had a substantial growth in recent years, although sales during the latter part of the fifties appear to have leveled off. Nevertheless, the industry continues to be very optimistic about the possibilities for future growth, particularly in view of the technological improvements that are constantly being made in the machines themselves to increase their usefulness.

Advantages of Automatic Vending. The basic advantage of automatic vending is that it is a convenient method of buying and selling small items. The machine is available at all hours for impulse buying and does not require the presence of salespeople. Thus it is an ideal selling medium for certain types of convenience goods, especially in those cases in which undue expense would be incurred if a personal selling operation were to be installed. The selling of soft drinks at gasoline service stations, cigarettes in restaurants and hotels, and coffee and milk in industrial plants are typical examples of situations in which automatic vending is likely to be both convenient and economical in relation to alternative methods of selling.

In some instances, regular retailers sell certain products by means of auto-

[23] These operators own and service machines which are located in manufacturing plants, service stations, hotels, restaurants, and other places that have a heavy traffic of potential buyers.

[24] Aaron Sternfield, "The Salesman Who Never Sleeps," *Dun's Review and Modern Industry*, February, 1957, p. 54, as reprinted in Alfred L. Seelye (ed.), *Marketing in Transition* (New York: Harper, 1958).

[25] More than forty different products are listed by G. R. Schreiber, *Automatic Selling* (New York: Wiley, 1954), p. 19.

[26] It is stated that more than one out of every five plants in the United States uses vending machines exclusively for employee meals. *Printers' Ink*, November 22, 1957, p. 39.

[27] For accounts of some of these experiments, see Marshall, *op.cit.*, esp. Chaps. 7–11. More recent developments are recited in the *Printers' Ink* article, *ibid.*, pp. 37–9.

matic vending machines rather than by conventional methods. These are likely to be small items carrying a low markup. The use of machines releases shelf space for more profitable items, reduces pilferage, and permits salespeople to concentrate on products which require personal selling effort. Although these advantages may be important ones, the question arises of whether the sales volume of the machine-vended items is as great as it would be if they were sold in the regular manner. Little is known about this but at least one study—admittedly of limited scope—found that the sale of cigarettes in a restaurant declined in relation to sales of nearby competitors when a change was made from counter selling to automatic vending.[28] Although this is an isolated example, it does point up the fact that there are difficulties associated with automatic selling.

Disadvantages of Automatic Vending. Although it has just been noted that convenience is a principal advantage of automatic vending, there are nevertheless numerous inconveniences involved in buying from machines. For one thing, they are limited in their stocking capacity and may run out of merchandise before time for the regular service call of the operator. This results either in inconvenience to the customer or in greater expense to the operator for special service. Machines are also limited in the variety of brands and items that they can handle. Even a modern cigarette machine carries only a small proportion of the more than 100 brands, types, and sizes of cigarettes that are available on the market today, thus definitely limiting the customer's selection. Finally, there are mechanical failures. Modern technology has done much to reduce these to a minimum but they still exist. And there is nothing else quite so irritating to the customer, an irritation which may be expressed by a more or less violent pounding of the machine with the probable result that additional damage will be done to it.

Automatic vending appears to present numerous difficulties when used as a method of selling bulky and heavy merchandise, shopping goods, and higher-priced merchandise. There are obvious physical limitations of machines which preclude entirely the sale of certain products. But there still may be difficulties even if physical limitations are of little consequence. The consumer cannot touch or examine merchandise that is dispensed by machine. There is no salesperson available to answer questions about the product and to explain the significance of size and quality designations. In any event, the variety of merchandise offered for sale is limited, a fundamental disadvantage in selling shopping goods. Even in women's hosiery, which has been sold somewhat successfully by automatic vending methods, only standard sizes can be dispensed and the selection of colors is limited. Moreover,

[28] Richard R. Still, "The Effect of an Automatic Vending Machine Installation on Cigarette Sales." *Journal of Marketing*, July 1953, pp. 61–3.

the price charged tends to be rather inflexible and thus at times somewhat above the general market level. Most attempts to sell merchandise at a price higher than a dollar have met consumer resistance. The prospective buyer usually is inconvenienced by having to obtain numerous coins and then by having to insert them into the machine. Although the development of a machine that will take paper money and that can make change in amounts up to $10 has been announced, it remains to be seen whether shopping goods and high-priced products can be sold successfully by automatic vending methods.

A final limitation to the development of automatic vending is that it is basically a high-cost method of retailing. Marshall found expense ratios in excess of 25 per cent of sales for most operators with ratios of 35 to 50 per cent, and even higher, not at all uncommon.[29] Thus gross margins are likely to be at least as great as those of competing retail stores for the same products and in numerous instances probably greater. High operating costs exist for several reasons. Vending machine operators must pay commissions to location-owners and still bear the costs involved in servicing and maintaining the machines. Moreover, the investment in machines can be very substantial. The cost of candy and cigarette machines is not too great, but a substantial investment is required to operate machines dispensing cold drinks, coffee, milk, and other products with special requirements. Thus machine depreciation is a major item of expense for many operators, along with servicing costs and commissions to location-owners. If high traffic locations can be obtained, expense ratios can be kept at moderate levels since machine depreciation and servicing costs are relatively fixed. Thus volume is the key to low-cost operations, but high traffic locations are limited in number and not necessarily easy to obtain.

Conclusions. Automatic vending has had a substantial growth in recent years and will probably continue to grow. It does not, however, pose a serious competitive threat to the retail store. The bulk of its sales volume has been obtained in a few categories of convenience goods. Expansion of sales volume in these lines is expected to continue, and further experimentation no doubt will take place with other convenience and semiconvenience merchandise and with specialized operations such as the vending of toilet articles in college dormitories and the provision of automatic food service on trains and in industrial plants. From time to time, efforts have been made to establish a fully automatic supermarket but through the use of key-operated rather than coin-operated machines. To date, these efforts have not been particularly successful, although it is claimed that the consumer can save a significant amount

[29] See Martin V. Marshall, *op.cit.*, pp. 103–22.

of shopping time.[30] Even a guess would be hazardous as to what the future will bring in this respect, but the presently established automatic vending industry should continue to grow in importance in the sale of convenience goods and in the sale of various products where special conditions exist that make regular retailing methods unduly difficult or expensive.

SUMMARY

In this chapter we have examined the basic retailing structure: the number of retail establishments, sales volume, and the number of persons engaged in retailing. We have found that retailing is a very important part of the total marketing structure and that the retailer, like the wholesaler, is concerned with the performance of numerous marketing functions. We have also found that retailers may be classified in various ways: by type of operation, according to location, according to size, by merchandise lines handled, and according to the type of ownership and control that is involved in the operation of the establishment.

These several bases of classification provide the framework for the further discussion of retailing. In this chapter we have examined retail establishments according to the type of operation involved. Our analysis of mail order retailing, house-to-house selling, and automatic vending has been made in some detail considering that altogether they do less than three per cent of total retail volume. Nevertheless, they are distinctive types and of considerable interest to the student of marketing. And in the retailing of certain products each of these types is of some importance.

In the four following chapters, we shall continue the discussion of retailing according to the remaining bases of classification. The next chapter is concerned with the location and size of retail establishments. In Chapters 10 and 11 we shall discuss retail institutions classified according to the merchandise that they handle, and in Chapter 12 the various forms of ownership and control will provide the basis of the analysis. In all four of these chapters, the principal concern will be with retail stores.

[30] The first such store was developed by Clarence Saunders, who had previously originated the Piggly Wiggly stores, in Memphis, Tennessee, and was called the Keedoozle. It ceased operations in 1949. More recently, the Independent Grocers Alliance has attempted a similar operation. A key is utilized for the selection of merchandise and purchases are recorded on a tape. See *Printers' Ink*, November 22, 1957, p. 37.

QUESTIONS FOR DISCUSSION

Suggest whatever ideas you can to explain the following facts:

1. Between 1929 and 1939, the number of retail establishments increased by almost 20 per cent and the number of persons engaged in retailing by 10 per cent, whereas the physical volume of retail sales increased by only 6 per cent.
2. Between 1939 and 1948, the number of persons engaged in retailing increased by 40 per cent, the physical volume of retail sales by 22 per cent, but the number of retail establishments remained virtually unchanged.
3. Between 1948 and 1954, the physical volume of retail sales increased by 22 per cent, but the number of persons engaged in retailing rose by less than 1 per cent.
4. That after all of the above "abnormal" behavior, between 1954 and 1958 the physical volume of retail sales increased by 11.4 per cent and the number of persons engaged in retailing by 9.4 per cent.

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9. THE LOCATION AND SIZE OF RETAIL STORES

THE LOCATION OF RETAIL STORES

Retail stores are located, of course, wherever there is a sufficient concentration of population to warrant the establishment of the particular type and size of store desired. Retail stores, however, tend to locate in certain rather definite areas and thus to group themselves into clusters which may be called shopping districts or shopping centers. These shopping districts vary greatly in size and importance depending both upon the size of the city within which they are located and upon the specific location within the city itself. Thus there are two phases of location that are of interest: (1) the distribution of retail trade by size of city, and (2) the locational structure of retail trade within a city or metropolitan area. Each of these phases of location will be discussed in the following pages.

Distribution of Retail Trade by Size of City

Retail Trade and Population. It is evident even to the casual observer that most of our retail stores are located in urban areas and that these stores obtain a much greater proportion of total retail sales than do those located in rural areas. It is also logical to assume that stores located in cities obtain a larger sales volume than would be expected on the basis of their proportionate share of the total population, since large cities attract many "out-of-town" customers from smaller cities and from nearby rural areas. The actual comparison of retail trade to population shows, however, an interesting pattern. The data are presented in Table 9-1.

In this table, we are comparing the percentages of retail establishments (column 4) and the percentages of sales volumes (column 6) with the per-

centages of population (column 2) by city-size groups. Thus cities of 500,000 or more in population have 17.8 per cent of all retail establishments and 21.0 per cent of retail sales volume but only 17.6 per cent of total population. At the other extreme, towns of less than 2,500 population and rural areas contain 41.3 per cent of the population but have only 29.1 per cent of retail establishments and 19.5 per cent of sales volume. Dividing the percentages of establishments (column 4) and sales volumes (column 6) by the population percentages (column 2) of the various city-size groups gives us ratios of actual establishments and sales volumes to those expected on the basis of population (columns 7 and 8).

An examination of column 7 of the table indicates that the largest cities have about the expected number of retail establishments based on population. Cities of 500,000 or more have only 1 per cent more establishments than expected, and cities of 250,000 to 499,000 have only 4 per cent more. As cities become smaller, however, there is a consistent and constant increase in the ratio of establishments to population, with cities of 2,500 to 4,999 having 58 per cent more establishments than would be expected on the basis of population. Rural areas, of course, have fewer establishments than would be expected.

With respect to the sales volume ratios in column 8 of the table, the data show, as would be anticipated, that stores located in rural areas obtain less than one half of the sales volume that would be expected on the basis of population. Stores located in urban areas correspondingly obtain a greater proportion of sales volume than would be warranted by the populations of the respective city-size groups. However, the highest ratios of actual sales to expected sales are not found in the largest cities but rather in the cities of medium size. Those with more than 500,000 population have sales volumes only 19 per cent above expectations, whereas all city-size groups between 10,000 and 499,999 have sales volumes ranging from 44 to 52 per cent greater than would be expected according to population. Even those cities from 2,500 to 9,999 in population have higher sales volume ratios than do those of more than 500,000 inhabitants.

These data on establishments and sales volumes appear to indicate that there is a point of population level at which the large city ceases to be attractive as a retail shopping center, at least in relation to smaller cities. No doubt there are other contributing factors that help to explain the low ratios of establishments and retail sales volume to population in the largest cities. Nevertheless, there is evidence that retail trade is becoming more and more decentralized and that large cities—and in particular the central business

TABLE 9-1

Retail Trade Classified by City-Size Groups, United States, 1954, Compared with 1950 Population

City-Size Group (*number of inhabitants*)	*Population, 1950*		*Retail Establishments, 1954*		*Sales Volume, 1954*		*Ratio of Actual to Expected*	
	Number (in thousands) (1)	*Per Cent of U.S. Total* (2)	*Number* (3)	*Per Cent of U.S. Total* (4)	*Amount (in millions of dollars)* (5)	*Per Cent of U.S. Total* (6)	*Establishments* Col. (4) ÷ Col. (2) (7)	*Sales Volume* Col. (6) ÷ Col. (2) (8)
United States Total	150,697	100.0	1,721,650	100.0	169,968	100.0	1.00	1.00
Cites of:								
500,000 or more	26,523	17.6	305,791	17.8	35,774	21.0	1.01	1.19
250,000–499,999	8,288	5.5	98,425	5.7	13,430	7.9	1.04	1.44
100,000–249,999	9,494	6.3	129,514	7.5	15,858	9.4	1.19	1.49
50,000– 99,999	8,891	5.9	121,709	7.1	14,494	8.5	1.20	1.44
25,000– 49,999	8,740	5.8	128,338	7.4	14,884	8.8	1.28	1.52
10,000– 24,999	11,905	7.9	182,192	10.6	19,739	11.6	1.34	1.47
5,000– 9,999	8,138	5.4	137,423	8.0	12,796	7.5	1.48	1.39
2,500– 4,999	6,480	4.3	117,931	6.8	9,868	5.8	1.58	1.35
Areas of less than 2,500	62,238	41.3	500,327	29.1	33,125	19.5	0.70	0.47

Source: *U.S. Census of Business: 1954*, Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), pp. 11, 1–72. Percentages and ratios in columns (4) and (7) computed by the writers.

districts of these cities—are less attractive to the retail shopper than they once were.

The Decentralization of Retail Trade. During the nineteenth century and the early part of the twentieth century, the United States had a large rural population. Moreover, transportation was slow and it was not easy to travel from the farm to the city or from a small town to a nearby large city. During these times retail trade was widely diffused, as it must necessarily have been to meet the needs of the population. Then came the movement of population from the farms to the cities, a movement which reached a temporary peak during the twenties but which was resumed after World War II. Although specific census data are not available, it is generally understood that this movement of population resulted in a greater concentration of retail sales at the expense, of course, of stores located in rural areas. Moreover, the development of the automobile and its widespread adoption as a means of transportation during the twenties made it much easier for the resident of a rural area to shop in the cities. Thus the tendency toward the concentration of retail sales in the larger cities is believed to have been especially pronounced during this decade.

Beginning with the thirties, however, this trend appears to have been reversed and retail trade has gradually become more decentralized. The relevant census data for 1939, 1948, and 1954 are shown in Table 9-2.[1] The largest cities, those of 500,000 or more population, show a consistent decline in relative sales volume from 24.3 per cent of the United States total in 1939 to 23.2 per cent in 1948 and 21.0 per cent in 1954. The next two size groups do not show so consistent a trend, but cities with populations of 250,000 to 499,999 had lower relative sales in 1954 than in 1939 and those with populations of 100,000 to 249,999 had a higher relative volume. All smaller city-size groups and rural areas gained proportionally between 1939 and 1954, and the trend is generally a consistent one although of small magnitude in some cases. It is particularly interesting to note the comeback of the rural areas (places of less than 2,500 population) from 17.2 per cent of total United States sales in 1939 to 19.5 in 1954.[2]

[1] Data for 1929 are not available for the city size groups shown in Table 9-2. Such data as are available indicate a small decrease in relative sales volume between 1929 and 1939 for cities of 30,000 or more population, for cities of 2,500 to 5,000 population, and for rural areas, and an increase (from 18.5 per cent to 20.0 per cent of total retail sales) for cities of 5,000 to 30,000 population. See *U.S. Census of Business: 1939*, Vol. I, *Retail Trade*, Part 1 (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1943), p. 10.

[2] For a more thorough analysis of these changes as reflected in the 1939 and 1948 census data, see E. J. Sheppard, "The Growing Importance of the Small-Town Store," *Journal of Marketing*, July 1955, pp. 14–9.

TABLE 9-2

Percentage Distribution of Retail Sales Volume by City-Size Groups, United States, Selected Years

City-Size Group (number of inhabitants)	*1939*	*1948*	*1954*
Cities of:			
500,000 or more	24.3	23.2	21.0
250,000–499,999	9.4	7.6	7.9
100,000–249,999	8.9	9.6	9.4
50,000– 99,999	8.3	8.4	8.5
10,000– 49,999	19.1	20.1	20.4
5,000– 9,999	7.2	7.4	7.5
2,500– 4,999	5.6	5.4	5.8
Areas of less than 2,500	17.2	18.3	19.5

Sources: U.S. Census of Business: 1948, Vol. I, *Retail Trade*, Part 1, p. 14 and *U.S. Census of Business: 1954*, Vol. I, *Retail Trade*, p. 11, both from U.S. Department of Commerce, Bureau of the Census, Washington.

Thus a definite trend is indicated toward the decentralization of retail trade. This does not necessarily mean, however, that retail trade is returning to the same small towns and rural areas that lost trade during the twenties. On the contrary, the small cities and rural areas that are gaining sales volume now are suburbs of large cities and rural nonfarm areas adjacent to these suburbs and to the large cities. They are a part of the standard metropolitan area [3] of the large city, and it is the movement of population to these suburban areas that has resulted in the relative sales increases of the smaller city-size groups. For example, between 1950 and 1955, the population of the standard metropolitan areas of the United States increased by 11.5 million persons. The population gain of the central cities of these metropolitan areas, however, amounted to less than two million persons, whereas the population gains of the urban areas outside the central cities amounted to more than 4.5 million persons and of the rural areas outside these same central cities to five million.[4] The increases in population of other urban and rural areas were either nominal or nonexistent. Thus the movement toward decentralization of retail trade is not necessarily a general one but primarily one of de-

[3] For a definition of standard metropolitan area, see footnote 9 in Chap. 5.

[4] U.S. Bureau of the Census, *Current Population Reports*, Series P-20, No. 63, November 2, 1955. Preliminary data from the 1960 Census of Population indicate that these trends are continuing and that many central cities actually lost population between 1950 and 1960.

centralizing from the large central city to the suburban parts of the same metropolitan areas. This belief is supported further by data on retail sales volumes within central business districts, central cities, and standard metropolitan areas that will be discussed in the next section.

Locational Structure of Retail Trade Within a City

Retail stores tend to locate within a city or metropolitan area in a rather definite pattern. This locational structure reaches its highest degree of development in the larger cities and metropolitan areas, but even in relatively small cities some aspects of the structure are well developed and vestiges of other aspects can be observed. Retail stores thus may be classified according to their location within this structural pattern, as follows: (1) those located in the central business district, (2) those located on main business thoroughfares or string streets, (3) those doing business in secondary shopping districts, (4) those grouped into neighborhood clusters, and (5) those doing business in scattered individual locations.[5]

The Central Business District. Stores located in the central business district of a city draw customers from the entire trading area. Such stores tend to be the largest ones in the trading area and the dominant stores of their type. They are usually stores that emphasize shopping goods and, to a lesser extent, specialty goods. A certain number of convenience goods stores normally locate in central business districts, especially cigar stores and drug stores. Groceries and petroleum products, however, can usually be purchased more conveniently at less congested locations.

The central business district then is the main shopping center of the area. It is dominated by department stores and by large departmentized specialty stores. It does a large volume of business in men's and women's apparel, shoes, jewelry, dry goods, and general merchandise. A considerable volume of furniture and appliances are sold by stores located in the central business district, but in recent years the specialized furniture and appliance stores have tended to seek other locations.[6] The reason for this lies in the increasing congestion of the central business district. As a result, stores located in this area have been losing sales volume relative to stores located in

[5] For a more elaborate classification and a detailed analysis, see Eugene J. Kelley, "Retail Structure of Urban Economy," *Traffic Quarterly*, July 1955, pp. 411–30.

[6] Between 1939 and 1948, the sales of furniture, furnishings, and appliance stores located in the central business district of Seattle fell from 65 to 32 per cent of total sales of all such stores located in Seattle. See L. C. Wagner, "Retail Trends in Seattle," *Journal of Marketing*, July 1953, p. 54.

outlying areas in virtually all merchandise lines. In some cities, the decline in sales volume of the central business district has been absolute as well as relative, as will be shown later in Table 9-3.

String-Street Locations. String streets are main business streets or thoroughfares leading out of the central business district. They are heavily traveled streets with a substantial amount of automobile and public transportation traffic. On these streets are found all types of retail stores, stores that obtain more of their sales volume from people using the street than they do from nearby residents. String-street locations are especially attractive to dealers in convenience goods, such as gasoline service stations and grocery stores, and to certain types of specialty goods outlets, such as automobile dealers. When large shopping goods retailers, such as department stores, select string-street locations, a secondary shopping district is likely to develop around the location. Recent developments in the construction of high-speed expressways in large cities have probably reduced the importance and value of string-street locations to some extent, but there is little information as yet regarding the effect of these developments upon retail trade.

Secondary Shopping Districts. Since many people in a large city desire to shop close to home, secondary shopping districts exist to meet their needs. These districts are located in outlying and suburban areas and contain numerous stores of various types. There is a considerable emphasis upon convenience goods outlets, but shopping and specialty goods retailers also locate in secondary shopping districts. In general, shopping goods stores tend to be smaller and to carry smaller assortments than their downtown counterparts. Department stores located in secondary districts are in fact usually branches of the main downtown store and are controlled from the downtown location. Merchandise is usually purchased by the buyers of the main store and supplied to the branch.[7]

Most secondary shopping districts in the past have been unplanned or uncontrolled. That is, they developed naturally and conventionally as shopping centers in response to the needs of consumers and without the assistance of a central guiding force or specific over-all plan. Since World War II, there has been an important movement toward controlled or planned shopping centers. Such centers are developed by an independent promoter or by a dominant department store of the area. The developer acquires a certain amount of land, constructs the store buildings, provides for adequate parking space, determines the exact number of each type of retailer that will be permitted to come into the area, and in general plans all the details of the

[7] The trend toward the establishment of branches by department stores is discussed in the next chapter.

center. The result is an integrated one-stop shopping center designed to provide complete retail service for a definite suburban population area. The controlled secondary shopping district has become of such importance that it is discussed at considerable length in a subsequent section of this chapter.

Neighborhood Clusters. Throughout the residential areas of cities, one finds a small number of stores grouped together into neighborhood clusters. These stores consist almost entirely of convenience goods outlets and service establishments and are designed to serve the needs of the residents of the immediately surrounding area. A neighborhood cluster is likely to consist of one or two grocery stores, one or more specialized food outlets such as a bakery or a delicatessen, a drug store, possibly a small variety store, a dry cleaning establishment, a barber shop, and a shoe repairing business. The stores tend to be small in size and to carry limited assortments. They are usually family operated.

Scattered Individual Locations. In any urban community, one finds a certain number of scattered stores located in residential areas apart from other stores. They are usually very small in size and family operated. They tend to handle convenience goods. In general, they depend upon fill-in business and often obtain a considerable proportion of their volume by staying open evenings and on Sundays. In recent years, this type of store has found it more and more difficult to survive. The trend toward night openings by downtown stores, as well as those located in suburban shopping districts, and the tendency of supermarkets to stay open both in the evening and on Sunday has resulted in many instances in the elimination of the small family-operated store.

Conclusions. It is evident from the foregoing discussion that the retail structure of a city consists basically of a series of groups or clusters of retail establishments ranging from the large number of stores located in the central business district to the small neighborhood clusters and even individual stores. Stores locate in groups because consumers in some instances decide to shop for a particular good at several different stores before making a decision and in other instances desire to shop for many different items in one shopping trip. The basic factor determining the retail structure is convenience to the consumer, but convenience is not necessarily to be explained in simple terms.[8] Under certain circumstances, the consumer may find it more convenient to spend thirty minutes in driving to a major shopping center than to spend five minutes in walking to a neighborhood store that has a limited selection

[8] For a discussion of the various aspects of convenience, see Eugene J. Kelley, "The Importance of Convenience in Consumer Purchasing," *Journal of Marketing*, July 1958, pp. 32–8.

of merchandise. On the other hand, if the consumer knows that parking space will be difficult to find once the major center is reached, she may content herself with shopping at a smaller center in which merchandise selection is limited but parking space is plentiful.

There are many aspects of place, time, and selection convenience that determine consumer shopping habits. It is not necessary to discuss these various aspects at length here. But it is important to realize that consumer convenience and inconvenience are leading to changes in the retail structure.

Changes in the Locational Structure of Retailing

In the previous discussion of the decentralization of retail trade, we have noted the trend toward the growing relative importance of the smaller city-size groups. In part at least, this trend has been the result of two changes that have been taking place in the locational structure of retailing. These changes are the decline in relative importance of the central business district as a shopping center and the corresponding increase in secondary shopping districts, in particular the development of planned suburban shopping centers.

Decline of the Central Business District. The central business districts of many of our larger cities have been declining in relative importance as retail trading centers for a number of years. Since World War II, however, the trend has become a general one and much more pronounced. Between 1948 and 1954, the dollar volume of retail sales for the entire United States increased by almost 32 per cent. Out of 95 central business districts located in the larger standard metropolitan areas, however, 26 showed an actual decrease in dollar volume. Not a single central business district had an increase in sales volume larger than that for the entire city or the standard metropolitan area in which it is located. Table 9-3 shows for 25 selected cities the changes in sales volumes between 1948 and 1954 for the central business district, for the entire city, and for the standard metropolitan area. The data for these selected cities illustrate very well the general trend.

Reasons for Decline. Most recent studies of downtown and suburban shopping behavior indicate that the principal reasons for the decline in the central business district lie in the lack of available parking space and in the general congestion associated with the downtown area.[9] The lack of parking space, combined with rapid transit facilities which are often inadequate and

[9] See, for example, C. T. Jonassen, *The Shopping Center versus Downtown* (Columbus: Bureau of Business Research, The Ohio State University, 1955); and John P. Alevizos and Allen E. Beckwith, *Downtown and Suburban Shopping Habits Study of Greater Boston* (Boston: College of Business Administration, Boston University, 1954).

TABLE 9-3

Percentage Changes in Retail Sales Volume for Selected Cities of the United States by Trading Areas, 1954 in Relation to 1948

	Trading Area		
City	*Central Business District*	*Entire City*	*Standard Metropolitan Area*
Atlanta, Georgia	3.6	46.3	45.7
Birmingham, Alabama	2.0	24.3	21.0
Boston, Massachusetts	2.7	23.9	35.1
Chicago, Illinois	−5.1	17.0	27.8
Cleveland, Ohio	5.5	17.6	31.2
Dallas, Texas	−1.7	56.4	58.9
Denver, Colorado	3.3	39.4	52.7
Detroit, Michigan	−11.1	21.6	39.4
Houston, Texas	10.2	51.6	48.6
Indianapolis, Indiana	10.5	33.5	34.1
Los Angeles, California	−6.7	36.6	50.5
Louisville, Kentucky	15.0	36.8	40.8
Miami, Florida	11.2	56.7	69.5
Milwaukee, Wisconsin	−1.0	20.5	26.6
Nashville, Tennessee	1.5	28.2	33.0
New York, New York	4.9	12.5	25.4
New Orleans, Louisiana	9.8	25.5	37.4
Oklahoma City, Oklahoma	−3.3	41.4	42.0
Philadelphia, Pennsylvania	−6.0	17.3	30.6
Pittsburgh, Pennsylvania	−16.1	3.1	15.1
Portland, Oregon	−2.6	18.3	20.0
St. Louis, Missouri	−10.2	18.9	32.5
San Francisco, California	0.7	12.7	28.6
Seattle, Washington	5.1	35.9	35.7
Washington, D.C.	−2.0	8.8	35.8

Source: U.S. Census of Business: 1954, Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), pp. 13–4.

expensive, tend to make it difficult and inconvenient to shop in the central business district. The general traffic congestion existing in the downtown area and on the highways and streets that lead into the area add to the inconvenience and especially to the time that must be taken for the shopping trip. In addition, many of the principal stores in the central business district are located in buildings which are architecturally out of date and which have not been modernized. Both exteriors and interiors are often unattractive and uninviting. Facilities for customer service may be outmoded. This failure of the downtown store, and of the central business district generally, to keep

up with changing consumer tastes is believed by some authorities to be an important factor in their decline.[10]

Thus downtown shopping not only has become inconvenient and time-consuming but it tends to take place in outmoded facilities. In addition, population has been concentrating more and more in suburban areas at the expense of the central cities. It seems evident that the shopping disadvantages of the central business district and the movement of population to the suburbs are sufficient reasons to account for an increase in the relative importance of the secondary shopping district. However, recent developments resulting in the establishment of many new suburban shopping centers have added substantial impetus to the movement toward retail decentralization. In particular, the planned shopping center, with its new and modern buildings, attractive surroundings, accessible location, and ample parking space, has had a widespread appeal for the shopper.

The Planned Shopping Center. The rise of suburban shopping centers, and in particular of planned centers, is one of the most significant developments in modern retailing.[11] It is estimated that there were 3,700 shopping centers in operation at the end of 1959, with as many as 900 opening during that year.[12] Most of the existing centers have developed since World War II, and especially during the fifties, but some go back as far as the twenties and thirties. Most of these older centers now face problems of congestion similar to those of the downtown business district.

The planned or controlled shopping center is one that is planned in advance as an integrated shopping unit. The land and buildings are owned by a single agency, usually a developer or a department store. Different types of retail stores and service establishments are brought into the center, often being housed under one roof. The center is designed to obtain a harmonious grouping of stores offering a balanced assortment of goods and services that will encourage one-stop shopping. Particular emphasis is placed upon the provision of sufficient off-street parking space and upon the elimination of traffic congestion. Many of the larger centers have special landscaping features designed to provide attractive surroundings that will appeal to the shopper.

Suburban shopping centers vary greatly in size. At the one extreme, there are small neighborhood centers consisting of 10 to 15 retail and service out-

[10] See, for example, Paul H. Nystrom, "Revival of Downtown Shopping Districts," *Journal of Retailing*, Fall 1958, p. 131; and Victor Gruen, "Dynamic Planning for Retail Areas," *Harvard Business Review*, November–December 1954, p. 57.

[11] For a good discussion of this development, see Gordon H. Stedman, "The Rise of Shopping Centers," *Journal of Retailing*, Spring 1955, pp. 11–26.

[12] S. O. Kaylin, "7th Annual Report on Shopping Centers," *Chain Store Age*, May 1959, p. E29.

lets which serve from 2,500 to as many as 20,000 persons. The emphasis definitely is on convenience goods stores: one or two grocery stores or supermarkets, a drug store, various service establishments, and perhaps a variety store and a specialized apparel shop. Neighborhood centers are usually not so carefully planned as are the larger ones. Next in size is the community or district center serving a population as large as 50,000 or perhaps even 100,000. A number of specialty stores are added to the convenience goods outlets of the neighborhood center: appliance retailers, shoe stores, and various types of specialized apparel shops. Finally, there is the regional center which may serve an area containing several hundred thousand persons. The number of retail and service outlets will range from 50 to 100, including one or two department stores which are usually branches of the large downtown stores. The regional center thus attempts to give the shopper a wide choice of convenience, shopping, and specialty goods of all kinds and, to some extent at least, in various price ranges. The greatest amount of selling space is occupied by the department stores but every effort is made to provide a balanced assortment of stores, both competitive and complementary.

Impact of the Large Regional Center. Although some authorities have felt in the past that the shopping center of optimum size should be one drawing from a trade area of 50,000 to 100,000 persons, it appears to be the large regional centers that have had the greatest impact upon the retailing structure. For one thing, they are likely to be better planned than are many of the smaller centers.[13] Parking space is usually provided for several thousand automobiles compared to space for a few hundred that is often available in an unplanned secondary shopping district of equal or even greater size. Careful attention is paid to the problem of traffic flow, both vehicular and pedestrian, within the shopping center. And a special effort is made to provide attractive surroundings, with respect to both the interiors and exteriors of buildings and the surrounding landscape. In addition, the stores located in a large center are more likely to engage in organized cooperative promotional efforts. Thus the large regional center usually expects to draw customers from a considerable distance, as much as 30 minutes driving time from the center compared with 20 minutes for the community center and 10 minutes for the neighborhood center.

This combination of advantages then—adequate parking space, lack of congestion, pleasant surroundings for shopping, and cooperative promotional efforts—has resulted in a shift of retail trade, at least relatively and in some instances absolutely, from the central downtown business district to the

[13] See Victor Gruen, *op.cit.*, esp. pp. 55–6, for a discussion of planning and a description of the large Northland center of Detroit.

planned shopping center. But it is not only the central business district that has lost volume to the planned center. Unplanned secondary shopping districts of long standing are likely to feel some impact on sales volume when a planned regional center is located nearby.[14] Moreover, local neighborhood retailers are likely to be affected adversely, and it appears that even planned community centers often lose sales volume to new regional centers. Thus the planned suburban shopping center, especially the large regional center, has had a considerable impact upon the general retail structure, although the greatest impact no doubt has been upon stores located in the central business district.[15]

Limitations of Shopping Centers. Planned shopping centers do not represent, however, the complete or final answer to the problem of retail location. The studies of shopping behavior previously referred to indicate considerable consumer dissatisfaction with shopping centers.[16] In comparison especially with central business districts, suburban centers lack a sufficient variety of merchandise assortments and are believed to have higher prices than do the downtown stores. Many centers are also criticized for not having all kinds of business represented, a criticism that obviously is directed less to the large regional centers than it is to the smaller community or district centers. It is undoubtedly true, however, that merchandise assortments are more limited even in the larger suburban shopping centers than they are in the main downtown business districts, and it seems likely that there is also less price competition. For many shoppers, these are important disadvantages.

There are also other limitations of the suburban shopping center. As population increases in the surrounding areas, these centers also face the problem of congestion. Parking space becomes inadequate and, even if additional space can be provided, it must be located at a considerable distance from the center. Many of the older centers now find themselves in a situation not dissimilar to that of the downtown business district. Moreover, the development of new centers is not necessarily accomplished so easily and economically as it once was. Land and building costs are increasing, and the number of planned centers has about reached the saturation point, at least for the present, in some metropolitan areas. Financing in some cases has become difficult to obtain because of these factors.

Finally, suburban centers are facing increasing competition from the

[14] B. L. Shapker, "Effect of a Planned Shopping Center on an Older Center Serving the Same Area," *Journal of Marketing,* July 1956, pp. 71–3.

[15] For a discussion of the impact by specific lines of merchandise, see Charles H. Hindersman, "Impact of Shopping Centers on Trade in Downtown Cincinnati," *Journal of Retailing,* Winter 1959–60, pp. 185–96.

[16] See references mentioned in footnote 9.

downtown areas. Retailers in the central business district are making a concerted effort in many cities to solve some of their problems and to recapture sales volume that has been lost to the suburban centers. These efforts include special joint promotions to attract shoppers to the downtown area and more evening openings; improvement in public transit facilities and sometimes the payment of shoppers' fares; the provision of additional parking space, often underground, and the payment of customers' parking fees; the remodeling of existing store buildings to add space, relieve shopping congestion, and modernize appearance; and, most basic of all, providing the initiative for a general program of urban downtown renewal.[17] A number of cities are working on downtown renewal projects. These projects involve everything from slum clearance to the building of express highways. In an effort to relieve congestion, experiments are even being made with the establishment of pedestrian malls, that is, closing off to vehicular traffic several blocks of the principal shopping streets. Preliminary reports appear to be favorable but testing has been rather limited thus far. All of these measures are likely to be helpful, but it would appear that for the long run a general program of urban downtown renewal is necessary, including restrictions on vehicular traffic of the type mentioned, if the central business district is to be revived.[18]

Concluding Observations. Changes in the retail structure will continue to take place. Substantial increases in population are forecast for the future. Most of these additional people will live outside of the large central cities. Retail stores will follow the population. Thus there is every reason to believe that retail trade will continue to decentralize. Planned suburban shopping centers, an important factor in the decentralization movement, will expand in number and in importance, on a more orderly basis perhaps than in the past, but nevertheless at a significant rate. But there will also no doubt be many new, relatively unplanned, shopping districts and highway strip developments. The concept of vast interurban markets—land areas including two or more metropolitan centers and the surrounding densely populated regions—is already being advocated, as mentioned in Chapter 5, as a replacement for the concepts of metropolitan areas, central cities, and suburban markets. Retail stores will be located wherever necessary to serve these concentrations of population.

Central business districts no doubt will continue for some time to decline

[17] For an account of some of these developments, see "Downtown Loads Its Heavy Guns," *Business Week*, November 23, 1957, pp. 71–4.

[18] See Paul H. Nystrom, *op.cit.*, esp. pp. 131–2; also Wroe Alderson, "Here's How Stores Will Face It," in Alfred L. Seelye (ed.), *Marketing in Transition* (New York: Harper, 1958), pp. 69–77, reprinted from *Nation's Business*, November 1955.

in relative importance as retail trading centers, regardless of their efforts to reverse the existing trend. Nevertheless, they do perform important functions, particularly in the retailing of shopping goods. To the extent that cities are successful in relieving the downtown congestion, they will continue to perform these functions successfully and profitably. Many students of the problem believe that central business districts must be as carefully planned as are the present planned regional shopping centers. The downtown and suburban areas should be essentially complementary rather than competitive. Perhaps this objective can be accomplished, but it is likely to be very expensive and to require a significant amount of centralized control. There is little doubt, however, that the central business district of the future will be quite different from that of the present, and it appears likely that the necessary changes will be made to permit it to retain a significant place in the retail structure.

THE SIZE OF RETAIL STORES

The retailing structure of the United States presents many contrasts with respect to the size of retail establishments. Although the average size of retail stores has been increasing for a number of years, partly because of price increases and partly because of increases in the physical volume of merchandise sold, there are still many small stores. At the other extreme, there are relatively few large stores but they have a substantial proportion of total sales volume and retail employees. The data in Table 9-4 show these contrasts.

At the one extreme, the three largest groups of stores shown in the table, which include all establishments with an annual volume of $300,000 or more, constitute only 6.7 per cent of the total number of establishments, but they have 54.1 per cent of total sales volume and 48.4 per cent of total employees. At the other extreme, the two groups of stores with an annual volume of less than $30,000 per store constitute 40.5 per cent of all retail establishments, but they have only 5.1 per cent of total sales volume and employ only 5.6 per cent of all retail employees. Even those retailers in the next highest sales-size group, $30,000 to $49,000, have only 5.9 per cent of the sales volume compared with 17.5 per cent of the establishments. Although the data are not shown in the table, in 1958 there were only 1,295 retail establishments with sales of $5,000,000 or more, whereas there were 75,064 retailers with a sales volume for the year of less than $5,000. Only 3,795 establishments had 100 or more paid employees in 1958. Thus it is evident that retail store operations are conducted basically on a small scale, although the large firm does dominate the retail trade picture in certain respects.

TABLE 9-4

Retail Outlets[a] Classified by Sales Size Groups: Establishments, Sales Volume, and Paid Employees, United States, 1958

Sales Size Group (annual sales volume)	Establishments: Number	Establishments: Per Cent of Total	Sales Volume: Amount (in thousands of dollars)	Sales Volume: Per Cent of Total	Paid Employees[b]: Number	Paid Employees[b]: Per Cent of Total
$1,000,000 and over	25,178	1.5	58,590,778	31.1	2,012,131	27.3
500,000–999,000	35,740	2.2	24,601,860	13.0	833,041	11.3
300,000–499,000	49,125	3.0	18,765,654	10.0	717,422	9.8
100,000–299,000	265,346	16.1	43,482,285	23.1	1,858,439	25.3
50,000– 99,000	316,998	19.2	22,287,744	11.8	1,037,930	14.1
30,000– 49,000	288,178	17.5	11,131,225	5.9	488,232	6.6
10,000– 29,000	444,475	27.0	8,351,567	4.4	363,353	4.9
Less than 10,000	221,869	13.5	1,268,468	0.7	53,405	0.7
Total	**1,646,909**	**100.0**	**188,479,581**	**100.0**	**7,363,953**	**100.0**

[a] Includes only those outlets operated during the entire year.

[b] For work week ended nearest November 15.

Source: *U.S. Census of Business*: 1958, Advance Report, *Retail Trade, Sales Size* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1960), p. 2–2. Percentages computed by the writers.

The Small-Scale Retailer

Small retail stores have two main characteristics in common: their size and the fact that they are usually owner-operated. In other respects they vary greatly. They are found in nearly every type of retail business: groceries, drugs, hardware, lumber and building materials, electrical appliances, apparel, variety merchandise, and many others. Most small retailers, however, concentrate on a single line of merchandise, sometimes a complete line and sometimes a narrow line in a broader classification. Small stores are also found in nearly every type of location at which retail business is carried on, although many of them are located, of course, in neighborhood areas. Small retailers also vary greatly in the services they render. They may be self-service and cash-and-carry or they may offer any combination of services, including credit and delivery. Although the small retailer in virtually every merchandise line is confronted by substantial competition from large-scale firms, there are a number of inherent advantages of small-scale operation, advantages the utilization of which has permitted the small firm to continue to exist in such large numbers.

Advantages of the Small Retailer. Perhaps the most important advantage of the small store is its flexibility of operation, its freedom of action. The owner-operator can make decisions promptly with regard to all policies—buying merchandise, selling and sales promotion, pricing, opening and closing hours, and service—and without waiting for consultation with, or permission from, a superior who in any event may not have adequate knowledge of the particular problem or of local conditions. Thus there is an absence of "red tape" in the management of the small enterprise which permits that enterprise to adjust its policies quickly to meet changing conditions. In a field as dynamic and as competitive as retailing, this advantage of flexibility is an important one. As soon as the enterprise becomes sufficiently large to require the management efforts of more than one person, flexibility is sacrificed at least in some degree.

A closely allied advantage is the personal interest of the owner in the success of his enterprise, which gives him, presumably, a greater incentive to effort than has the hired employee of his large competitor. In addition, because the operation is small, he can exercise close personal supervision over his employees, and he has an important sales advantage through his personal acquaintance with his customers. He can obtain an intimate knowledge of their needs, buy his stock accordingly, and grant credit based upon personal knowledge. Furthermore, the friendly atmosphere often found in a small

independent store is frequently an important element in its continued success. Even though his store may not be very well managed, and though the prices asked may be a little higher than those of his larger competitor, the small store owner is often able to hold his customers because they like the friendly atmosphere of his store. Many customers like to have the proprietor call them by name and to be received as acquaintances and friends.

Finally, and contrary to general opinion, the actual operating expenses of very small stores are often surprisingly low. This is particularly true of stores operated by the owner and members of his family, with no hired employees. Sometimes the expense for rent is kept at a minimum by using the rear of the store building or an upper floor as a residence, and many other petty economics are practiced. It is evident, of course, that low expense ratios obtained in these ways are gained through the sacrifices made by the owner and his family, sacrifices that are not necessarily reimbursed adequately by the profits of the store. The small store with a sales volume of $10,000 per year will have a merchandise cost of $7,000 to $7,500, leaving $2,500 to $3,000 as the gross margin. Even though expenses are small, the balance remaining as compensation for the owner and his family seems definitely inadequate. Nevertheless, so long as consumers for one reason or another prefer to do business with the small retailer and so long as people can be found who prefer this occupation to others even though it may be less remunerative, the small retail store will continue to exist.

Disadvantages of the Small Retailer. The principal disadvantages inherent in small-scale retailing are limited buying power, limited financial strength, and the lack of specialization in management. Limited buying power is a handicap which every small retailer must face. He cannot buy individual products or even groups of related products in sufficiently large quantities to secure quantity discounts or "special" prices. Moreover, he is often limited as to his sources of supply. Because of the high cost of selling to small accounts, a constantly increasing number of wholesalers and manufacturers refuse to sell to these accounts or sell only after the addition of special service charges. Thus the small retailer is seldom able to buy on an equal basis with his large competitor.

Limited financial strength affects the operation of the small store in several ways. Failure to take cash discounts on merchandise purchased results in a loss of income. Necessary store improvements often cannot be made, and it may not be possible to employ adequate personnel. Of even greater importance perhaps is the effect upon sales promotional activities. The small store is often unable to spend very much money on advertising and other forms of promotion. Even if financing is available, it may be

difficult to find proper media. Newspaper advertising cannot be used to the best advantage, for the cost of effective advertising—particularly for the neighborhood store—is often too great in relation to possible sales to warrant the expenditure. Newspapers generally have a much wider circulation than the trading area of the small store,[19] and many small retailers have not learned how to use effectively direct mail advertising, handbills, and store and window displays.

This last statement points up the fact that the small retailer is handicapped by a lack of specialized managerial personnel. The operator usually must do the buying for the store, supervise and train his employees, plan his promotional activities and prepare promotional material, keep accounting records, and sell to customers. He can hardly be a specialist in all of these activities. Although wholesalers and manufacturers assist the small retailer in many ways, for example, by furnishing him with promotional materials and with accounting forms, he must still diversify his managerial efforts widely. Although poor management is not an inherent weakness of small-scale retailing, it is frequently found, partly because of this lack of specialized knowledge and partly no doubt for other reasons. The retailer who has an inadequate accounting system, inefficient methods of stock control, and poorly supervised salespeople is likely to have a mediocre store, with a small volume of sales and high prices. The mortality rate of small stores is high and the most commonly assigned reason for failure is poor management. Although many small stores do operate with great efficiency, it is probably true that the principal disadvantage of the small store in relation to its larger competitor is the superior management of the latter.

Large-Scale Retailing

Growth of Large-Scale Retailing. The increasing importance of large-scale retailing establishments has been an outstanding feature of marketing evolution during the present century. The development of department stores began after the Civil War, but the period of most rapid growth began about 1900 and continued for the next twenty years; from 1900 to 1915 the mail order house gained a prominent place; following World War I chain store systems developed rapidly, and by 1930 a few of the largest chains had developed a volume of business greater than that of the largest mail order houses and department stores. The largest chains are found in the grocery, variety,

[19] In large cities neighborhood newspapers, often distributed without charge to all homes, have developed in an effort to meet the advertising needs of neighborhood stores. Also some large city newspapers now run special suburban editions once a week.

and general merchandise fields, but they have become important in many other lines. The rapid growth of contract, or voluntary, chains began about 1926, and they have assumed great importance in the grocery field. The supermarket, also in the grocery field, came into existence in the depression years immediately following 1930 and has had a substantial growth since that time. The most recent type of large-scale establishment to develop is the discount house which began to assume importance after World War II.

The particular characteristics of each of these kinds of business—except for the mail order house which was described in the previous chapter—will be discussed at length in the three following chapters. Each has certain inherent advantages and disadvantages as a result of these characteristics. But all large-scale retail institutions have certain common advantages and disadvantages as a result of their size. These will be discussed at this point.

Advantages of Large-Scale Retailing. The principal advantages inherent in some degree in all large retail establishments are as follows: (1) superior management and specialization, (2) economy in overhead and other expenses, (3) effective buying, (4) effective sales promotion, and (5) the economies of integration.

Superior Management and Specialization. The very fact that an organization is large is often evidence of superior management. Most large retail organizations have developed from small beginnings. By superior management they have outdistanced their competitors and attained their leading position. One of the most important reasons for superior leadership is the ability to pay the high salaries that are necessary to obtain and retain high-grade executives, whose talents only firms operating on a large scale can fully utilize. These firms can apply the principle of division of labor to management. The result is greater skill in management, more effective control and coordination of departments, and more efficient distribution of authority.

The large-scale operations carried on also make it possible to have specialized departments. There can be, for example, special departments to take over the work of accounting, delivery, training, advertising, adjustments, credits, and finance; and buying is often divided among a number of specialists. Not only does this type of specialization make it possible to utilize particular skills of highly paid executives, but the personnel in each department can be hired and trained for the special work of a single department. The firm is able to employ the skill and time of each member of the staff to the best advantage.

Economy in Overhead and Other Expenses. Aside from the economy that arises from utilizing the full time of highly paid experts and of a specialized staff in those activities in which they are most proficient, other economies

in expense are possible for large organizations. The overhead expenses of the firm—rent, heat, light, delivery, and the like—are spread over a large volume of business, and so may be less per unit of sales than in smaller establishments. The cost of effective advertising is likely to be less per unit of sales than it is for competing small establishments. The department store, advertising a sale of electrical appliances, will draw customers who will also buy clothing, hardware, and other products, whereas the small specialty store handling but one line of products cannot expect such favorable results.

The financial strength of the large store also results in additional savings. All regular cash discounts can be taken on merchandise purchases, and not infrequently special cash discounts can be obtained from manufacturers who are short of funds. Moreover, large stores are often in a position to finance themselves. Even when they borrow money with which to pay cash for current needs, such firms obtain better terms from banks and investors than those offered to their smaller competitors. In contrast, many small stores are forced to depend very largely upon the credit extensions of wholesalers and manufacturers. Consequently, through higher prices on their merchandise purchases, or directly, they pay an interest rate on the credit they receive which is much higher than that paid by the larger firms.

Effective Buying. Effective buying is one of the major advantages of the large retail organization. The use of specialists is one of the important contributing factors to effective buying. The large retailer can employ buyers who specialize in the merchandise of a single department, frequently in a very narrow line of that department. They have a thorough knowledge of the goods to be purchased, as well as of qualities, styles, costs, and market conditions. Smaller dealers cannot afford to hire experts of this class; more than likely the proprietor himself does the buying, in addition to his other duties.

The buyers for large retail establishments are also usually in a position to obtain the best prices available in the market. They buy in large quantities and are able to demand the largest quantity discounts that are being offered. They have the facilities to search the market for the lowest prices. In fact, they sometimes pay lower prices than do many of the wholesalers who handle similar items and who in turn supply the small retailer. Although special price concessions to large buyers are not so prevalent now as they once were, due to the provisions of the Robinson-Patman Act,[20] the large retailer usually has a price advantage in his buying, and he is often able to obtain special

[20] This Act provides that quantity discounts must be justified by savings in the costs of manufacturing, selling, and delivery of the larger quantity and that advertising and other special allowances must be made available to all buyers on a proportionately equal basis. See Chap. 28 for a further discussion.

buys at bargain prices from manufacturers, wholesalers, or importers who are overstocked.

The purchase of goods at favorable prices is not the only advantage the large retailer has in buying. He is usually in a position to select better assortments of merchandise than is his smaller competitor. He can afford to keep reasonably complete records of past sales and to use these as a basis for future purchases. Most buyers for large retail establishments thus are better able to forecast customer demand—to know the sizes, colors, qualities, and price lines that will be desired by the market—and to stock the appropriate merchandise. Moreover, these buyers are constantly in touch with the market, seeking out new and improved products for their customers. Most large stores have buyers or agents in the principal domestic markets, and sometimes even in important foreign centers, who are alert to the latest trends and who can purchase new products and the latest fashions.

Effective Sales Promotion. Although large retail organizations have not been noted for the efficiency or the effectiveness of their personal selling efforts, they do have certain advantages in relation to the small retailer with respect to advertising and sales promotion, including the services they render to customers. The large organization again can employ specialists in advertising, window display, and other such fields, who can provide the expert knowledge necessary to carry out a successful promotional program. Moreover, the large retailer can take advantage of all available advertising and promotional media, whereas the small store usually cannot afford to advertise in the newspapers or over television and radio because the expense would be out of all proportion to the results. The larger the city the greater is the number of stores that cannot use these general media, and the greater is the institutional prestige and good will attached to the large retailers who can publicize themselves and their merchandise in these ways.

Although the service policies of large retailers vary greatly, many of them treat service as an integral part of their promotional program. Even in those fields in which the large firms operate basically as nonservice stores, as in food retailing, they tend to set the service standards of the industry. People become accustomed to self-service and cash-and-carry methods but demand wide assortments and compensating prices. On the other hand, many large retailers have emphasized complete service as a part of their merchandising plan. They extend credit, give free delivery, accept returned merchandise without question, provide rest rooms, take care of young children, sell transportation and theatre tickets, and perform many other services designed to attract customers to the store. Obviously, the small store finds it impossible to compete on the same basis.

Economies of Integration. The final major advantage of large-scale retailing arises from the more economical operations and the competitive advantages which often result from the integration of retailing with wholesaling and manufacturing. Most large retailers do engage in vertical integration, at least with respect to wholesaling activities, and such integration often results in better service to the retail stores and in reduced operating expenses. By performing the wholesale operations, the business establishes closer contacts with the ultimate sources of the supply of merchandise, and it may effect savings in demand-creational activities and in other marketing expenses. Selling expenses between the integrated steps are eliminated or reduced to a minimum. Credit extensions and collection costs are eliminated between the integrated steps, production and marketing activities are more effectively coordinated, and the abilities of the specialists within the organization can be more fully utilized. Manufacturing operations, although less frequently carried on, are of some importance. Chain stores, mail order houses, and department stores frequently own or control plants manufacturing some of the products they sell. The high degree of integration that results from the control of manufacturing operations increases technical and administrative problems and has by no means always been successful. In some cases, however, such operations have resulted in obtaining an assured supply of important products, products better suited to the firm's market, or lower prices.

Finally, it should be pointed out that the integration of marketing operations which affect the retailer has not been confined to the integration of wholesaling or manufacturing by the large retailer. Manufacturers are assuming wholesale, and in some cases retail, functions by selling directly to retailers or consumers. Wholesalers are reaching out in both directions. A few conduct some manufacturing operations, and many are sponsoring contract chains, operating supermarkets, and entering the retail field in other ways. Consumers are cooperating in order to secure control of the retail function and sometimes of the wholesale and manufacturing functions as well. These developments are discussed further in Chapters 12 and 15.

Disadvantages of Large-Scale Retailing. The disadvantages of large-scale retailing can be more briefly stated, but they should not for that reason be underestimated, since very distinct difficulties confront these large organizations. The first of these is the danger that the *costs of doing business* will become excessive. As small organizations become large, unit costs often decrease, but as organizations continue to grow there is a tendency toward increasing costs. In order to become large and to remain large, retailers must

create a very great demand for their merchandise. This is likely to necessitate a substantial expenditure for advertising and service. In addition, it may be necessary to locate in high-rent shopping centers. Many large retailers use low price as the major sales appeal to attract clientele from a wide area, and thus must also fight high costs. A major problem of many such firms is that they start out as nonservice organizations and then, in order to attract or hold trade, gradually add services that increase costs of operation and so limit their low-price appeal.

The advantage derived from spreading overhead expenses over a large volume of business was discussed previously. But unfortunately, the increase in the *kinds* of overhead charges which large stores must bear tends to offset these advantages, and in addition some types of overhead expense are increased. With regard to services, for example, a particular service may cost less per unit of sales for a large store than for a small one, but the total expenses for services tend to be larger per unit of sales because large stores are likely to offer more elaborate services than do their smaller competitors. The exaggerated services offered by many department stores have resulted in increased costs of operation, thus adding to their pressing problems of expense control. Many large specialty stores also offer extensive services. Chains, supermarkets, and discount houses, and to some extent mail order houses, are thought of as establishments operating with a minimum of service, but they are not entirely immune to the pressure for service. Mail order houses offer liberal return privileges, and their use of instalment selling adds to the cost of goods to their instalment customers. Chain stores, supermarkets, and discount houses often attempt to improve their competitive position through obtaining high-rent locations and by the use of expensive buildings and equipment.

Again, large organizations must depend upon *hired employees*. Hired employees in the lower ranks in particular are proverbially less efficient in their work, less courteous, and less effective in selling than the same individuals would be in operating their own establishments or working under the close supervision of small operators. If they have no investment or other permanent interest in the business, the incentive to efficient service is peculiarly lacking. But, like so many generalizations concerning large and small stores, this contrast must not be pushed too far. Many independent stores are not well managed, and on the other hand, careful training, high salaries, and expensive systems of accounting, supervision, and control have been quite effectively used by large organizations in solving their personnel problems. It must also be recognized that many men work better under super-

vision and that large organizations in all fields of business are commonly supervised by hired executives. Finally, the fact that hired employees who do not do effective work are soon discharged keeps up the average of performance.

There is often lacking in the large store that *personal relationship* which usually exists between the proprietor of the small store and his customers. The general absence of a feeling of friendliness toward large corporations undoubtedly has its effect in causing some customers to prefer small dealers or to impose on any large firm they do patronize.

Finally, there is the matter of flexibility of operation. It has previously been stated that the small store can adjust more quickly to changed conditions and that management decisions can be made more easily and with less "red tape" than is true for the large store. The *inflexibility* of the large retail organization is a definite disadvantage. Again, however, much has been done to overcome this problem. More and more authority and responsibility are being delegated to subordinates in the organization. Local managers and departmental managers are often permitted to make important decisions without first referring the problem to higher executives. Much progress has been made in recent years in streamlining the large organization and adapting it to the dynamic competitive situation that is generally found in the retailing field. Nevertheless, there are some decisions that cannot be delegated and some problems that cannot be solved by decentralizing authority and responsibility. The alert and competent owner of a small store will always have some advantage over the large store in flexibility of operation and promptness in decision making.

QUESTIONS FOR DISCUSSION

1. It might be of some interest to study the ratios in columns 7 and 8 of Table 9-1 and to advance hypotheses and ideas as to why the relationships shown there do exist. The answers are by no means obvious. For example, one possible hypothesis is that the cities of medium size, which do have the higher sales volume ratios, also have higher average incomes, and that this would account for the differences in sales volumes. This hypothesis has a certain amount of plausibility since many of the medium-size cities are suburbs of larger cities, and it is usually assumed that the more well-to-do tend to live in the suburbs. A graduate student of one of the writers has explored this hypothesis rather thoroughly, however, and it does not appear that differences in income constitute an explanation.
2. It has been pointed out in this chapter that there are many small retailers and that their operations on the whole cannot be very remunerative. It has been

stated by some that the social costs of small-scale retailing are high and that many of the proprietors of the 220,000 stores with less than $10,000 in sales in 1958 could well have been employed elsewhere with more profit to themselves and to society. Others state that this judgment is not valid, that it may be a cost to the individual but not to society in a free and competitive economy. So long as the individual proprietors are satisfied and so long as consumers choose to patronize these small retailers, the result is acceptable from the social point of view. Evaluate these two points of view. What issues are really involved?

3. Vertical integration was discussed in Chapter 2 and in the present chapter and will be further considered in Chapter 15. There is a very real question as to whether vertical integration generally leads to significant economics. One point of view is that the large retailer involved in backward integration does not have to integrate completely and thus tends to integrate only those product lines for which it appears that there will be a saving in cost. On the other hand, the manufacturer who decides to integrate forward into wholesaling and/or retailing does so in order to obtain market representation and control and often because there is little alternative. Thus forward integration is not likely to result in lower costs whereas backward integration usually does. Discuss this argument now and again after reading Chapter 15.

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10. RETAIL INSTITUTIONS

The fourth method of classifying retail establishments, as outlined in Chapter 8, is by merchandise lines handled or kind of business. The typical retail store is classified by the Bureau of the Census into one of a large number of merchandise groups according to the predominant type of merchandise that it handles. Some stores do not concentrate on any particular line of merchandise and are classified as general merchandise stores. Examples of this group are department stores, variety stores, and general stores. Most retail establishments, however, obtain a major portion of their sales volume from a single merchandise line, or closely related lines, and can be classified into a specific merchandise grouping, such as grocery stores, women's apparel stores, drug stores, hardware stores, automobile dealers, and many others.

The fact that a specific retail establishment is classified in one of these merchandise groupings does not mean that it does not handle other types of merchandise. Nor does it mean that it handles exactly the same lines of merchandise as does every other store in the group. For example, the large complete food store which is commonly called a supermarket sells a wide line of food products: dry groceries, meats, fresh fruits and vegetables, and bakery products. Such a store is classified by the Census as a grocery store, since dry groceries constitute the major portion of its sales volume. In addition to the food lines, however, many such establishments also carry a variety of household goods, toilet articles, and drug sundries. Moreover, the smallest store handling dry groceries only is also classified as a grocery store, although it is perhaps no more closely related to the supermarket than are the small meat market or fresh fruit and vegetable store which are classified in their respective product groups rather than as grocery stores. It is evident then that there are difficulties in determining classifications, as well as difficulties in allocating a particular store to a classification. Nevertheless, the census data do give a good picture of the retail structure by kind of business.

RETAIL STRUCTURE BY KIND OF BUSINESS

The number of retail establishments in the United States and the sales volumes of these establishments for 1958 are shown in Table 10-1 for all major merchandise groups and for many of the numerous subgroups. This table presents a good general picture of the retailing structure as well as some of the detailed characteristics. Food stores, of which grocery stores are the

TABLE 10-1

Retail Trade by Kind of Business: Establishments and Sales Volume, United States, 1958

Kind of Business	Establishments: Number	Establishments: Per Cent of Total	Sales Volume: Amount (in thousands of dollars)	Sales Volume: Per Cent of Total
Total Retail Trade	1,788,325	100.0	199,646,463	100.0
Lumber, Building Materials, Hardware, and Farm Equipment Dealers	108,248	6.1	14,309,206	7.2
Lumber and Building Materials Dealers	34,867	2.0	7,122,631	3.6
Hardware Stores	34,670	1.9	2,717,163	1.4
Farm Equipment Dealers	19,008	1.1	3,185,715	1.6
All Other Stores	19,703	1.1	1,283,697	0.6
General Merchandise Group	86,644	4.8	21,879,106	11.0
Department Stores	3,157	0.2	13,359,467	6.7
Variety Stores	21,017	1.2	3,620,600	1.8
Other General Merchandise Stores	62,470	3.5	4,899,039	2.5
Food Stores	355,508	19.9	49,022,333	24.6
Grocery Stores	259,796	14.5	43,696,343	21.9
Meat Markets	23,844	1.3	2,327,038	1.2
Fruit and Vegetable Stores	12,689	0.7	505,355	0.3
Candy, Nut, and Confectionery Stores	17,593	1.0	527,752	0.3
Retail Bakeries	19,235	1.1	904,981	0.5
All Other Food Stores	22,351	1.3	1,060,864	0.5
Automotive Dealers	93,656	5.2	31,807,877	15.9
Passenger Car Dealers (franchised)	38,555	2.2	25,325,753	12.7
Passenger Car Dealers (nonfranchised)	25,331	1.4	2,983,491	1.5
Tire, Battery, and Accessory Dealers	20,912	1.2	2,425,481	1.2
All Other Dealers	8,858	0.5	1,073,152	0.5
Gasoline Service Stations	206,302	11.5	14,178,203	7.1
Apparel and Accessories Stores	118,759	6.6	12,525,451	6.3

(Continued on next page)

TABLE 10-1 (*Continued*)

Kind of Business	*Establishments*		*Sales Volume*	
	Number	*Per Cent of Total*	*Amount (in thousands of dollars)*	*Per Cent of Total*
Furniture, Home Furnishings and Equipment Stores	103,417	5.8	10,074,227	5.0
Furniture and Home Furnishings Stores	54,458	3.1	5,988,949	3.0
Household Appliance, Radio, and Television Stores	28,459	1.6	3,276,421	1.6
All Other Stores	20,500	1.1	808,857	0.4
Eating and Drinking Places	344,740	19.3	15,201,481	7.6
Drug and Proprietary Stores	56,232	3.1	6,778,926	3.4
Other Retail Stores	240,140	13.4	18,468,340	9.2
Liquor Stores	37,068	2.1	4,201,958	2.1
Antique and Second-Hand Stores	21,155	1.2	639,748	0.3
Sporting Goods Stores	11,552	0.6	623,791	0.3
Hay, Grain, and Feed Stores	16,782	0.9	3,117,292	1.6
Jewelry Stores	23,751	1.3	1,494,770	0.7
Fuel and Ice Dealers	28,559	1.6	3,472,659	1.7
Florists	19,176	1.1	638,397	0.3
All Other Stores	82,097	4.6	4,279,725	2.1
Nonstore Retailers	74,679	4.2	5,401,313	2.7

Source: *U.S. Census of Business: 1958, Retail Trade, U.S. Summary* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1960), pp. 1–5 to 1–8. Percentages computed by the writers; they are not necessarily equal to group totals and may not add to 100 because of rounding.

most important single component, constitute approximately 20 per cent of all retail establishments and have almost 25 per cent of total retail sales volume. Eating and drinking places and gasoline service stations are the only other merchandise groups (except for the miscellaneous category of "other retail stores") with more than 10 per cent of total establishments—19.3 per cent and 11.5 per cent respectively. However, eating and drinking places obtain only 7.6 per cent of total sales volume and gasoline service stations have only 7.1 per cent.

With respect to sales volume, the highest ranking groups after food stores are the automotive group with almost 16 per cent and the general merchandise group with 11 per cent. Both of these groups rank low, however, in number of establishments, each having about 5 per cent of the total. The automotive group is dominated by franchised passenger car dealers which constitute only 2.2 per cent of retail establishments but which, because of the high unit value of the products sold, have almost 13 per cent of total dollar volume. Similarly,

the character of the general merchandise group is influenced most by the department store subgroup, which obtains almost 7 per cent of total dollar sales with less than one quarter of one per cent of total establishments. Comparisons of establishments ratios with those of sales volumes can be made for other kinds of business by studying the table. Such comparisons show rather clearly the extent to which a given merchandise group or subgroup consists generally of large or small establishments.

Changes in Structure

The number of retail establishments increased from 1,668,479 in 1948 to 1,788,325 in 1958, a gain of 7.2 per cent. At the same time, dollar sales volume increased by 55 per cent, from $128.8 billion in 1948 to almost $200 billion in 1958. These over-all figures, however, do not indicate the changes that have taken place within the various kinds of business. Table 10-2 shows the relative changes in number of establishments and in sales volume that took place between 1948 and 1958 for the various major merchandise groups and for a few of the more important subgroups.

It can be seen from the table that the most significant decline in relative number of establishments took place in the food stores category. In 1948 food stores constituted 27.6 per cent of total retail establishments whereas in 1958 they constituted only 19.9 per cent. Moreover, there was a decrease in absolute numbers as well as in relative numbers, from 460,913 in 1948 to 355,508 in 1958. Sales volume, however, increased somewhat between the two years in relation to total retail sales. Thus consumer patronage has remained high but the number of stores has decreased substantially. Actually this is a continuation of a trend that began in the early thirties with the rise of the supermarket. Large food stores, both chain and independent, have replaced many small stores. This has resulted in a decline in the total number of stores, a trend which has been continuous since the late thirties, despite substantial stability in relative sales volume.

Further examination of Table 10-2 reveals that, between 1948 and 1958, there were above average increases of some significance in the number of establishments for four merchandise groups: lumber, building materials, and hardware; general merchandise stores; furniture, home furnishings, and equipment stores; and other retail stores. However, no one of these groups showed an increase in relative sales volume. The furniture and equipment group maintained a stable proportion of sales volume, about 5 per cent of the total in each year, whereas the other three groups declined significantly in relative

TABLE 10-2

Percentage Distribution for Selected Kinds of Business of Retail Establishments and Sales Volume, United States, 1948 and 1958

	Per Cent of Total Establishments		*Per Cent of Total Sales Volume*	
Kind of Business	*1948*	*1958*	*1948*	*1958*
Lumber, Building Materials, and Hardware Group	5.8	6.1	8.6	7.2
General Merchandise Group	4.3	4.8	12.3	11.0
Department Stores	0.2	0.2	7.3	6.7
Variety Stores	1.1	1.2	1.9	1.8
Food Stores	27.6	19.9	22.7	24.6
Grocery Stores	21.0	14.5	19.2	21.9
Automotive Group	5.1	5.2	15.6	15.9
Passenger Car Dealers (franchised)	2.6	2.2	12.4	12.7
Gasoline Service Stations	10.8	11.5	5.0	7.1
Apparel and Accessories Stores	6.7	6.6	7.5	6.3
Furniture, Home Furnishings, and Equipment Stores	4.8	5.8	5.1	5.0
Eating and Drinking Places	19.5	19.3	8.3	7.6
Drug and Proprietary Stores	3.3	3.1	3.1	3.4
Other Retail Stores	11.8	13.4	10.0	9.2
Nonstore Retailers	0.3	4.2	1.8	2.7

Source: The 1958 figures are from Table 10 1. The 1948 data are from *U.S. Census of Business: 1954*, Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957). Sales volume figures are from p. 8; establishments figures were computed from data on pp. 1–5, 1–6, 1–7.

volume. There seems to be little economic justification for the large increase in number of establishments shown by these four groups, at least in comparison with other segments of the retail economy. The situation is only slightly different for apparel and accessories stores. In this case, the proportionate number of establishments remained almost constant while the proportion of total sales volume declined significantly.[1]

On the other hand, there are two kinds of business in the retail economy which are gaining in proportionate sales volume more rapidly than they are in relative numbers of establishments. These are gasoline service stations and

[1] Comparable data for 1954 have not been shown in Table 10-2, but they are available or have been computed from the source indicated. In general, they show that these changes were taking place in 1954 also, verifying that they appear to be trends and not isolated phenomena. Lack of comparability of the 1929 and 1939 census data makes it impracticable to extend the analysis further.

the automotive group, especially franchised passenger car dealers.[2] The sales volume gains of these two groups reflect largely the ever increasing role of the automobile in the American economy, a trend that has been in evidence for several decades. More surprising perhaps is the failure of retailers of automotive products to gain significantly in numbers of establishments. For passenger car dealers, the explanation may be that manufacturers, through their power to grant franchises, have kept numbers down. In addition, the capital requirements for a franchised dealership are rather high.[3] As for gasoline service stations, it can only be pointed out that this group has always had a large number of establishments in relation to the share of the retail sales dollar obtained. Even in 1958, service stations constituted 11.5 per cent of all establishments but obtained only 7.1 per cent of retail sales. Thus they are essentially a small-scale operation, and there may well be a question as to the economic justification at present for additional establishments even though sales volume is increasing steadily.

TYPES OF RETAIL INSTITUTIONS

It is not possible, nor is it necessary, to discuss in detail each type of retail institution classified in the various merchandise groupings of the census. It is evident that most stores can be classified according to the predominant type of merchandise handled. These stores are usually designated as single-line, or more accurately perhaps as limited-line, stores. The characteristics of the various limited-line stores are similar regardless of the particular merchandise involved. Therefore, a discussion of the limited-line stores will include a substantial majority of the retail institutions shown in Table 10-1. Of the general merchandise stores, two are of particular interest to the student of marketing and warrant a somewhat detailed discussion. These are general stores and department stores. In addition, there are two retail institutions not specifically classified in the census groupings, the supermarket and the discount house, which are generally recognized as special types. Each of these five types of retail institutions has developed in response to the economic environment existing at the time and thus has tended to replace other retail institutions in the process. Accordingly, they will be presented in the order

[2] The year 1958 was not a very good one for automobile sales. More typical perhaps was 1954 when the automotive group's share of total retail sales was 17.6 per cent and that of franchised passenger car dealers was 14.8.

[3] Nonfranchised passenger car dealers increased from 16,634 in 1948 to 25,331 in 1958, a large relative gain. These are generally small operations in comparison with the franchised dealer who must meet certain requirements of the car manufacturer. Franchised dealers actually decreased from 43,960 in 1948 to 38,555 in 1958.

of their historical development: the general store, the limited-line store, the department store, the supermarket, and the discount house.

The General Store

A general store carries a wide variety of merchandise and has no departmental organization. Groceries commonly make up a large proportion of sales, but drugs, hardware, dry goods, notions, and staple items of apparel are often carried, and not infrequently farm implements, seed, feed, gasoline, and oil. Very few general stores are now found that carry all classes of merchandise. There are, however, stores in many small communities which handle several lines of convenience goods. Shopping goods are not ordinarily sold by general stores since consumers prefer to go to larger places to purchase them.

From pioneer days down to the beginning of the twentieth century, the general store was the typical retail establishment in the United States. It was a peculiarly American development and was not, like so many of our early institutions, inherited from Europe. In fact, very few such stores are to be found anywhere else in the world.[4] The general store is particularly adapted to sparsely populated areas and is now found principally in small agricultural villages, in logging camps and mining camps, at country crossroads, and in outlying sections of cities. As recently as 1929, it was still a rather important factor in the retailing structure of the country with more than 7 per cent of all retail establishments and over 5 per cent of total retail sales. During the thirties, however, it declined rapidly in importance and has continued to decline since that time.[5]

The principal advantage of the rural general store is its ability to supply the people in its immediate community with the goods they want, quickly, and at a moderate price. The rural merchant has a personal acquaintance with his customers; he knows their needs and the class of merchandise they are likely to buy. Usually he has low operating expenses. Rent is low, help is likely to be cheap and easy to obtain, and he has, ordinarily, no delivery expense. This, together with the fact that his own living expenses are low, often makes it possible for him to compete in price with the stores in the larger towns. These fundamental advantages, however, are frequently minimized because of poor management.

[4] Paul H. Nystrom, *Economics of Retailing*, 2nd ed. (New York: Ronald, 1919), p. 23.

[5] In 1939 general stores constituted 2.2 per cent of total establishments and obtained 1.9 per cent of total retail sales volume. The corresponding figures in 1954 were 1.0 and 0.6. Census data for 1958 are not complete with respect to general stores, but a further decline is indicated both as to establishments and sales volume.

Chief among the disadvantages of the country general store is the fact that the comparatively small demand for any one of the many lines that must be carried makes it difficult to carry full assortments of anything. Wide variety from which to choose was not important when customers were less particular in their buying, the number of their wants was small, and they had no convenient and economical means of reaching urban stores. But the growing demand for a greater variety of goods from which to choose and for a better quality of merchandise has brought about marked changes in the status of the general store. Furthermore, the advent of the automobile and good roads has made it possible for rural residents to visit the larger trading centers. The general store, accordingly, has restricted itself more and more to convenience goods and even to a single line of convenience goods, such as groceries. Most of the establishments once classified as general stores in census reports are now classified as single-line stores in a particular merchandise group. Thus general stores have tended to reduce the number of merchandise lines handled, whereas the limited-line store, as will be noted in the next section, has tended to diversify its lines.

The Limited-Line Store

As the general store was the typical retail institution of the nation in the eighteenth and nineteenth centuries, the limited-line store is the predominant type of retail institution in the United States today. As population increased and as urban areas grew in size, the single-line store replaced the general store. Many of these new stores concentrated on very narrow lines of merchandise and were almost literally single-line stores. Most such stores today are not so restrictive in the merchandise lines carried. Thus it appears desirable to use the term "limited-line" to designate this particular type of retail institution.

A limited-line store concentrates its efforts on a single line of merchandise and handles a reasonably complete assortment of that line. It may, however, stock limited, or even relatively complete, assortments of other merchandise lines. Thus grocery stores usually sell fresh meats and fresh fruits and vegetables, as well as dry groceries, and may handle also limited assortments of household goods, toilet articles, and drug sundries. Drug stores stock wide assortments of drugs and toilet articles but also sell stationery, candy, magazines, gift items, ice cream and soft drinks, and many other products. Hardware stores handle a wide variety of products, some of which—such as glassware and dishes—appear to have no relationship at all to the regular hardware lines. On the other hand, some limited-line stores—for example, meat markets,

retail bakeries, fresh fruit and vegetable stores, small jewelry stores—sell only a single line of merchandise. Perhaps the best definition of a limited-line store is that it is one which handles a reasonably complete assortment of a single line of merchandise and obtains over half of its sales volume from that line.[6]

The principal advantages of the limited-line store, in relation to the general merchandise store, is the specialization of effort that is permitted by concentrating on a single line or a few related lines. Buying can be performed more expertly and without the necessity of seeking out widely scattered sources of supply. Customer needs can be evaluated more accurately and sales promotion can be planned accordingly. It is usually not necessary to organize the store on a departmental basis; thus accounting and other records need not be elaborate and complex. In addition, since most limited-line stores are small and are owner-operated, they also have the advantages of small-scale operation which were discussed in the previous chapter.

The disadvantages of the limited-line store result primarily from the fact that it does concentrate on a single line of merchandise or a few related lines. To the extent that this concentration results in a small-scale operation, the limited-line store has the disadvantages of small-scale retailing, which are substantial, as has been noted previously. Even if it is large, the limited-line store has certain shopping disadvantages in relation to the general merchandise store. Customers can obtain only the one line of merchandise, or at best a few lines. They must move on to another store, or to several stores, to complete their purchases. For many shoppers, it is much more convenient to purchase all of their food requirements at a single supermarket than it is to visit four or five single-line stores. Similarly, it is easier to purchase some articles of clothing for the entire family at a single department store than to visit a men's furnishings store, a women's apparel shop, a children's clothing store, and a shoe store. While one is waiting for a prescription to be filled, he might as well pick up a ball-point pen, a box of candy, or even some lawn chairs. The more limited the line the less is the opportunity of the store to sell merchandise on impulse and the greater is the danger that the shopper will seek out the general merchandise store.

The result in recent years has been a significant trend toward what is called "scrambled merchandising." Although most retail establishments can still be classified as limited-line stores under the definition given above, there has been a constant and consistent tendency for such stores to add merchan-

[6] Basically this is the method used by the Census in classifying stores into merchandise groups. If less than 50 per cent of the sales volume of a store is obtained from any single line, that store is classified in the general merchandise group and would not be a limited-line store.

dise lines. The obvious reasons for this are to attract "one-stop" shoppers, to obtain impulse sales, and to diversify risks. Thus most grocery stores now carry complete food lines, whereas there used to be many stores that stocked dry groceries only. Some men's apparel stores have added complete lines of women's clothing. Hardware and drug stores have diversified greatly, and grocery stores have added toilet articles, drug sundries, and household goods. In many instances, retailers are able to add high-margin fast-moving items from other merchandise lines which "skim the cream" of those lines from a sales point of view but which do not add greatly to expenses, since no effort is made to carry complete stocks or the slower-moving products.[7] How far this movement toward diversification of line will go is impossible to say, but there is no indication as yet that it has reached its peak. There has presumably been some benefit to the consumer not only in convenience but also in the increased competition that has been created. Eventually, however, it would seem that expense ratios must be increased and management efforts diversified to such an extent that prices might have to be raised. When and if this happens, no doubt there will be a reversion to single-line retailing.

The Specialty Store. Despite the trend toward wider merchandise lines, there still remain many stores that sell a limited variety of goods in a single line. When this line is a shopping good or a certain type of specialty good, the store is known as a specialty store. A retail outlet handling women's sportswear is, for example, a specialty shop, since it handles only a small part of the general line of dry goods and women's wearing apparel. Other types of specialty stores which have been particularly successful are millinery shops, and stores specializing in the sale of men's hats, women's dresses, optical goods, and musical instruments.

This type of store has the advantage of extreme specialization. The owner can become a specialist in buying and selling his particular line. He can develop a wide knowledge of the wholesale markets or other sources of his merchandise. He can make a careful study of quality and prices, and may become an expert buyer. He may, moreover, have some of the buying advantages of much larger organizations. For, although his business may be comparatively small, his line is so limited that he may buy the products he does carry in large quantities. Confining his efforts to a single line, he is able to train his sales force to sell his particular product effectively. More complete stocks can be carried than are likely to be found in the average store carrying

[7] This is largely what has happened in the case of the drug products now being sold by grocery stores. In some states, drug store proprietors have attempted to obtain state laws prohibiting the sale of any drug, even aspirin, by a retail outlet which does not have a registered pharmacist on duty at all times. Counter proposals by the food industry would prohibit drug stores from maintaining sandwich and lunch counters.

a number of lines. The stock can be kept up to date and include all the latest fashions. There is the possibility of rapid turnover, since the proprietor is able to watch his stock carefully, purchase what is most likely to sell to his particular trade, and see to it that slow-moving articles are promptly sold.

Certain disadvantages of the specialty store may also be pointed out. The owner's risks are highly concentrated, particularly if the merchandise is subject to repeated fashion changes. Fashions may change so that the demand for his product greatly decreases or even ceases to exist. This happened, for example, in the case of women's blouses during the twenties. Fashion decreed that women should wear short skirts, and since short skirts and blouses were not becoming to most women, there was practically no sale for blouses, and most of the special blouse shops went out of business. Seasonal fluctuations in sales present another difficult problem to the specialty retailer, and his limited line obviously does not tend to induce many impulse purchases.

The Departmentized Specialty Store. Stores which carry a complete line or a few closely related lines of shopping or specialty merchandise and which are large enough to be organized on a departmental basis are called "departmentized specialty stores." They carry wider lines of merchandise than do the regular specialty stores but narrower lines than do department stores. They usually carry a more complete assortment in the lines which are handled than do department stores. Departmentized specialty stores are found chiefly in the distribution of men's and women's clothing and accessories in large cities. Their principal competition tends to come from department stores, and they have many of the advantages and some of the disadvantages of the latter. The following discussion of department stores is also applicable in a large degree to departmentized specialty stores.

The Department Store

The department store is a retail institution that handles a wide variety of merchandise grouped into well-defined departments for purposes of promotion, service, accounting, and control. It is a large store which caters primarily to women, and is usually located in a downtown or large outlying shopping district.

The origin of department stores is uncertain. They are generally believed to have existed in Europe before they developed in the United States.[8] A

[8] Alfred Marshall believes that the first true department stores arose in France. The Bon Marché and the Louvre were established in Paris about 1852. These in turn, he believes, received their inspiration from English cooperative experience. See Alfred Marshall, *Industry and Trade* (London: Macmillan, 1920), pp. 295–6. But the greatest development has occurred in the United States. See Paul H. Nystrom, *Economics of Retailing* (New York: Ronald, 1930), Vol. I, pp. 127–46.

few departmentized stores appeared in the United States in the 1860s, among which were Jordon Marsh and Company of Boston and A. T. Stewart of New York. The most probable explanation of their origin is that they were a natural outgrowth from the dry goods store, and it is known that many present establishments started in this way. As the gross margin on piece goods became less and less with increasing competition in the retail field, the owners of dry goods stores naturally turned to women's factory-made clothing, notions, and other articles related to their trade which the development of manufacturing had brought on the market. From each new article it was but a step to the next, until convenience in handling and the necessities of management must have led to departmentization. Then, with departmentization established and the idea in mind, extension into other fields than dry goods and related products naturally followed.

Characteristics of Department Stores. The department store is distinguished from other retail establishments by three principal characteristics. First, it is distinguished by the nature of the goods it sells, and not by the mere fact that it carries a variety of commodities. Variety stores, departmentized specialty stores, and some drug stores carry a wide variety of merchandise, but they are not department stores. The tendency in department store lines is to supply all of the retail needs of the customer, with the exception of groceries and meats; but the sale of shopping goods and some specialty lines is stressed and the sale of convenience goods is relatively unimportant. Unless dry goods, women's ready-to-wear, and house furnishings are carried, a store is usually not called a department store. Other lines commonly carried include women's clothing accessories, piece goods, and small wares. Secondly, it is departmentized; that is, the merchandise is divided into classes, each one of which is distinct as to management and location within the store. Each department has its own manager, often called a buyer, but all departments are centrally controlled. Such general activities as advertising, accounting, credit, delivery, employment, and training are carried on by centralized departments. Third, the department store is large. Unless a store has at least 25 employees, it is not classified by the Census as a department store.[9]

Because of the merchandise lines carried and the fact that it is a shopping store, the department store is usually regarded as primarily a woman's store. Almost all department stores carry men's furnishings, however, and most have complete men's clothing departments which draw male patronage.

[9] In 1954, 61 per cent of all department stores had sales of one million dollars or more, which constituted 93 per cent of all department store sales. *U.S. Census of Business: 1954*, Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 18.

In order to attract male shoppers, these departments are often set apart from the rest of the store, sometimes with separate entrances. Some of the larger stores have a separate men's building. Some stores have experimented with special shopping nights for men only, reportedly with substantial success.

Because of its size the department store must have a location to which large numbers of customers can be easily drawn. Thus it is found, almost without exception, in downtown shopping centers or in the larger outlying and suburban shopping centers of large cities. Furthermore, department stores seem to be most profitable when competitive stores are grouped together in shopping centers, although there are some exceptions.

Special Operational Features. There are three important aspects of the operations of department stores that warrant mention. These are basement stores, leased departments, and branch stores. Each has its own particular effect upon the internal organization and operation of the department store.

Basement Stores. Although the operation of the basement floor of some department stores is no different from the operation of any other part of the store, there is still a strong tendency to regard it as a separate unit. Under this arrangement, the basement store carries merchandise of the same general type as is carried in other parts of the store but of a lower grade and at a lower price. There is likely to be a basement manager in general charge of the operation with managers and buyers for the various basement departments who are separate and distinct from those of the main store. The basement store is an outgrowth presumably of the old-time "bargain basement" in which merchandise was sold which had not moved satisfactorily in the main store. In addition job lots of merchandise were purchased at attractive prices for sale there. Present-day basement stores are regular merchandising operations that merely carry merchandise of a different quality and price. Thus they appeal to a different class of consumers from those patronizing the main store and also afford regular customers the opportunity of purchasing less expensive merchandise.

Leased Departments. A leased department is one which is controlled and managed by an independent operator, the space being rented to him by the main store. Leasing departments in which highly specialized merchandise is carried, or departments which have proved unprofitable to operate, is fairly common among department stores.[10] In 1954, 1,320 department stores, almost

[10] In 1954 there were 18,806 retail stores of all types with one or more leased departments. In addition to those in department stores, important types of leased departments included meat markets in grocery stores; eating establishments in drinking places, in variety stores, and in drug stores; shoe and millinery departments in apparel stores; and repair services. See *U.S. Census of Business: 1954*, Vol. I, *Retail Trade*, *op. cit.*, pp. 6–11 to 6–14.

half of all such stores, contained 5,289 leased departments with a sales volume of $377 million. The departments most often leased include shoes, millinery, household appliances, radio and television, beauty shops, and photographic studios. Lessees often lease the same department in a number of stores, thus forming a chain of departments. The principal advantage of leasing to the department store is that it permits it to offer a complete line of goods and services to the consumer without diversifying its own management efforts into unrelated and unfamiliar lines. Credit and other consumer services, however, are usually rendered to the leased department by the main store. Although the lessee is supposed to follow the general policies of the store in dealing with customers and similar matters, this is sometimes difficult to control and ill will created by the lessee's method of doing business may reflect upon the main store. Nevertheless, leased departments appear to be increasing in number and importance.[11]

Branch Stores. As population has moved to the suburbs and new shopping centers have been established, department stores and departmentized specialty stores have resorted more and more to the establishment of branch stores in an effort to maintain sales volume and profits. Branches are normally located in the general area served by the parent store, although some have also been established in summer and winter resorts. The character and importance of branch stores vary greatly. Some are small suburban stores with limited assortments; others are complete department stores. Few branches, however, carry the variety of price lines and the depth of merchandise assortments that are carried by the parent store.

The distinguishing feature of a branch store as compared, for example, with a chain store unit is that it is controlled from the parent store. Merchandise is purchased by the buyers of the parent store, usually warehoused by the parent store, and supplied by the parent store to the branch upon requisition. Buyers of the parent store are likely to be held responsible for certain aspects of the operations of the branch, including departmental profits. At the same time, they have little control over branch personnel. This control is usually given to a branch manager who essentially is in charge of the selling function for the branch store with little or no responsibility for buying. The result is that there is often divided authority, substantial difficulty in fixing responsibility for operating results, and the danger of friction between the branch manager and the buyers of the parent store.[12]

[11] Between 1948 and 1954, leased departments in department stores increased by almost 50 per cent in number and by almost 20 per cent in sales volume.

[12] See Clinton L. Oaks, *Managing Suburban Branches of Department Stores*, Business Research Series No. 10 (Stanford: Graduate School of Business, Stanford University, 1957), esp. Chap. 2.

More and more branch stores are being established each year and in general their sales are increasing more rapidly than are the sales of the parent stores.[13] There is every reason to believe that this trend will continue. In order for branch stores to realize their full potential, solutions to the management problem must be found. Some organizations are decentralizing authority and are giving the branches more responsibility for buying. In general, this is expensive since it results in a duplication of executive personnel. The more common solution may be to integrate operations to an even greater extent and give the buyers of the parent store more authority over departmental personnel of the branch.[14] In any event, organizational improvements need to be made, and probably will be made, in branch operations.

Ownership and Control. Department stores, like other retail institutions, have undergone many changes in ownership during the past two or three decades. While virtually all of them originated as independently owned organizations, two thirds of all department store sales are now made by multiunit organizations consisting of four or more units. Although some of these multiunit organizations consist merely of branch operations, the majority are chain store units.

There are two types of chain store organization found in the department store field. The first is the regular centrally owned and operated chain such as the larger stores of Sears, Roebuck and Company, the J. C. Penney Company, and Montgomery Ward and Company.[15] The other is the so-called "ownership group," which is characterized by central ownership but with little centralized control of the individual units. Ownership groups are made up largely of formerly independent stores that have come under the control of a single overhead company. The individual stores usually have continued to operate under their original names, and each store has a high degree of autonomy and individuality in its operations. The central organization provides financial management for the chain, maintains buying offices, compiles statistical information on operations, and conducts research. The individual stores, however, make all decisions with respect to actual operations including buying. The two largest ownership groups in volume of sales are Federated Department Stores, Inc., with more than 40 units, and the Allied Stores Corporation with approximately 85 units.[16]

[13] See the reports of Malcolm P. McNair, *Operating Results of Department and Specialty Stores* (Boston: Harvard University, Graduate School of Business Administration, issued annually).

[14] A solution of this type is advocated by Clinton L. Oaks, *op.cit.*

[15] This type of chain operation is discussed in Chap. 12. It should be noted here that not all retail units of the three organizations mentioned are classified as department stores. Many are too small and do not carry a sufficient variety of merchandise lines.

[16] For a listing of the ten largest department store chains with 1957 sales and profits,

Importance of Department Stores. For many years, department stores were perhaps the leading institutions of American retailing, despite the fact that they constituted a very small proportion of the total retail establishments of the country. They did obtain, however, an appreciable part of the retail volume in the larger cities and they took the lead in many merchandising and service innovations. They popularized and promoted fashion and initiated new and generally more liberal policies with regard to credit, delivery, and returned goods. In recent years, department stores have encountered difficulties. High operating costs, combined with increasing competition from low-cost retailers, the movement of population to the suburbs and the decline of the central business district, changes in consumer tastes, and outmoded methods of operation have combined to cause the department store to lose some of its former dominant position. Leadership in retailing is now more likely to be assumed by those institutions—such as the chain store, the supermarket, and the discount house—which emphasize price, administrative efficiency, and reduced services than by the independent department store.

TABLE 10-3

Department Stores: Number of Establishments and Sales Volume, United States, Selected Years

Year	*Number of Establishments*	*Sales Volume*	
		Amount (in thousands of dollars)	*Per Cent of Total Retail Sales Volume*
1929 [a]	4,221	4,350,098	9.0
1939 [a]	4,074	3,974,998	9.5
1948	2,558	9,431,842	7.3
1958	3,157	13,359,467	6.7

[a] Data for 1929 and 1939 are not comparable with those for 1948 and 1958. See text discussion.

Sources: U.S. Census of Business: 1958, Retail Trade, U.S. Summary, p. 1–5; *U.S. Census of Business: 1954,* Vol. I, *Retail Trade,* p. 1–7; and *U.S. Census of Business: 1948,* Vol. I, *Retail Trade,* Part 1, p. 1.04. All sources are from the U.S. Department of Commerce, Bureau of the Census, Washington. Percentages computed by the writers.

The decline in the department store is indicated by the data in Table 10-3, although the data overstate the case. The reduction in the number of estab-

see *Business Week,* May 31, 1958, p. 56. This article also contains an interesting account of Federated's operation.

lishments between 1939 and 1948 is due more to different methods of enumeration and to better reporting than it is to actual changes in the number of stores.[17] Moreover, the sales volume figures prior to 1948 include the sales of the large departmentized mail order houses, which were included in a different category—nonstore retailing—in 1948 and 1958.[18] The effect of these differences is not possible to determine, but it is probable that the actual decline between 1939 and 1948 in the percentage of total retail volume obtained by department stores is about one half to two thirds that shown in the table. Nevertheless, even this amount indicates that department stores are having some problems, and the additional decline in relative sales volume between 1948 and 1958 strengthens this conclusion. Before examining these problems at greater length, it is necessary to consider the particular advantages and disadvantages of the department store as a retail institution.

Advantages of the Department Store. The advantages and disadvantages of large-scale retailing in general have been reviewed in some detail in the previous chapter, and so only those advantages particularly applicable to the department store will be discussed at this point. The same procedure will be followed in discussing other large retail establishments.

Convenience in Shopping. Compared with the limited-line store, the department store offers important conveniences to its customers. It is pre-eminently *the* shopping store. With its many lines under one roof, the shopper can complete her purchases without leaving the store, and the display of many different lines of goods suggests additional purchases. It is located in a central retail district, often in an imposing structure where the shopper trades among pleasant surroundings. The mere size of the department store has an effect upon the buying public. Large stores usually have a reputation for reliability and the store building may even be said to serve as a symbol about which the firm's good will can be built.

Services. In the effort to attract large numbers of people, the larger department stores in particular have come to offer an almost unbelievable elaboration of services, most of which are free and many of which have no direct connection with the sale of goods. The most customary services include the sale of goods on approval, generous adjustments on unsatisfactory mer-

[17] In 1948 department stores were so classified if they had 25 or more employees. Prior to that time, the size requirement was $100,000 or more in sales volume. Also the Census indicates that there was better reporting of sales by merchandise lines in 1948, thus permitting it to classify a number of stores into specific merchandise groups that had previously been classified as department stores.

[18] The original tabulations of the 1948 Census included the sales of 22 mail order houses in the department store category. The data shown in the table are the revised 1948 figures issued with the 1954 Census. The difference amounts to 0.8 per cent of total retail sales, i.e., 8.1 per cent rather than the 7.3 per cent shown in the table.

chandise, free delivery, the filling of telephone orders, and liberal extension of credit. Other common services include rest rooms, reading and writing rooms, personal shopping bureaus, interior decorating service, fashion shows, gift wrapping, facilities for checking parcels, information bureaus, and telephone booths. Some large stores also have branch offices for the payment of utility bills, branch post offices, travel information bureaus, art exhibits, supervised play rooms for children, and lost and found departments. Beautiful and even spectacular store decorations, courteous service, and the smart appearance of employees, particularly in the ready-to-wear departments of the better stores, are all intended to create a pleasing store atmosphere.

All of these services and conveniences are offered in the hope of inducing customers, especially women, to acquire the habit of coming to the store. They have played an important part in the growth and development of department stores; but they have also been an important cause of the constantly increasing costs of doing business. Competition has played a large part in this ever-increasing elaboration of services, and it has been said with some degree of truth that some department stores have spent more time watching their competition than their customers. Thus, in the effort to keep ahead of their competitors, they have added service upon service, not always in response to demands of customers, but services which the customers must nevertheless pay for in the end.

Disadvantages of the Department Store. In addition to the disadvantages which it has in common with other large-scale merchandising institutions, the department store has some disadvantages which are either peculiar to its methods of operation or at least of particular importance.

Expense of Departmentization. While departmentization aids in the operation and control of the store and assists in locating unprofitable merchandise lines, it adds to the record-keeping costs of the store and causes waste in the time of some employees. It may be presumed that the operating knowledge gained from departmental records more than offsets the cost of maintaining these records, but the time wasted by departmental employees is possibly another matter. Thus there are slack times in the work of many salespeople and assistants in the various departments that could be taken up in a nondepartmentized store by the performance of other necessary duties. To offset this in part, some employees in the larger stores are trained to work in several departments as need arises, and large use is made of part-time employees. Nevertheless, it is not infrequently the case that a customer must wait for sales service, or go unserved, in a certain department while salespeople in a nearby department are standing idle.

Personnel Limitations. All forms of large-scale retailing have personnel problems, but those of the department store appear to be especially difficult. Many different types of persons must be employed, for 30 to 60 per cent of a department store's employees are engaged in nonselling activities. At the same time, a large contingent of salespeople is required. Both men and women are employed on a large scale. Moreover, many part-time employees are necessary to fill in during peak sales periods.

All of this leads to unusual problems of recruitment and training. Moreover, sales per employee appear to be below the level of some of the department store's principal competitors, and this no doubt is somewhat responsible for the fact that the rate of compensation paid to the majority of employees is somewhat on the low side. Consequently, there is a high rate of employee turnover. Most department stores have some form of personnel department to cope with these problems, but much remains to be done in the field of personnel and employee relations.

High Costs of Operation. There are many reasons for the high costs of operation of department stores, but one of the chief factors undoubtedly is the cost of the elaborate services described above. Service competition among department stores gained a great deal of momentum during the twenties and probably reached its peak during the late thirties. Starting with expense ratios of 25 to 26 per cent of sales in 1920, department store costs gradually rose to a level in excess of 36 per cent in 1938.[19] During World War II, many services were curtailed and expense ratios were reduced to 27 to 29 per cent of sales. Since the war, however, costs have again increased and present expense ratios are at a level of 33 to 34 per cent. In comparison, supermarkets operate with ratios of 16 to 18 per cent of sales and some discount houses achieve an even lower figure.[20]

It does not follow, of course, that the prices charged by department stores are always higher than those charged in competing stores offering fewer services. In many instances, the higher costs of operation are offset by the lower prices at which the department store is able to buy merchandise. This point is important because department stores have placed great emphasis upon buying at low prices. They often perform wholesale operations and buy directly from manufacturers. Even though the individual large department store has great buying power, the tendency for many years has been

[19] These and other ratios in this paragraph are taken from the annual surveys of the Division of Research of the Harvard Graduate School of Business Administration. See note 13 for the current author and title.

[20] See John W. Wingate, "Department Stores and the New Competition," in Robert D. Buzzell (ed.), *Adaptive Behavior in Marketing* (Chicago: American Marketing Association, 1957), p. 15.

for department stores, even the largest ones, to organize themselves into buying groups and thus to augment their already substantial buying effectiveness. This ability to buy merchandise at low prices permitted the department store for many years to maintain competitive prices despite the high costs of service. Since World War II, however, new forms of retail competition have arisen, and meeting this competition is one of the important problems of the department store that will be discussed in the next section.

Problems of Department Stores. The decline in the importance of the department store since World War II has resulted from the occurrence of a number of events. The combination of events has been referred to as the "retail revolution." Because of the nature of its operations, the department store has found it difficult to adjust to these events. The most important of these events with respect to the department store situation are (1) the movement of population to the suburbs and the decline of the central business district, (2) changes in consumer tastes, and (3) new competition from low-cost retailers. These are the problems facing department stores, and their success in meeting these problems will determine their future place in the retailing structure.[21]

Decline of the Central Business District. The fortunes of the department store, more than those of any other retail institution, have depended upon the development of the central business district. As population has moved to the suburbs and as downtown traffic has become more and more congested, the central business district has declined in importance and so has the department store. This development has been discussed at length in the previous chapter and the discussion need not be repeated here. The important point is that the department store must find some way to adjust to this situation. Efforts at adjustment have been made for some time but complete success has been difficult to achieve. The department store has a heavy investment in its downtown facilities, and its organization is geared basically to a single store operation. Nevertheless, branch stores have been established in suburban areas and regional shopping centers have been developed in an effort to follow the population. There is considerable evidence that these developments are assisting department stores in general, but not the downtown units specifically, to hold their own against further sales losses. Consequently, additional developments of this type will take place in the future, but the

[21] For interesting discussions of these problems, see Malcolm P. McNair, "Significant Trends and Developments in the Postwar Period," in Albert B. Smith (ed.), *Competitive Distribution in a Free High-Level Economy and Its Implications for the University* (Pittsburgh: University of Pittsburgh Press, 1958), esp. pp. 19–22; and John W. Wingate, *op.cit.*, pp. 10–23.

department store still has not solved the problem of successful branch store organization and management.

Finally, the department store in many instances is now taking the lead in downtown rehabilitation. Many individual stores have made substantial investments in modernization and improvement of their physical plants. They have attempted to provide adequate parking space in the downtown area for their customers. And they are cooperating closely with municipal authorities and civic groups in plans for the general improvement of the central business district. The success or failure of these plans will have considerable bearing on the future of the department store.

Changes in Consumer Tastes. Consumer spending patterns have changed significantly in the postwar period. Expenditures for automobiles and automotive products, for durable goods generally, and for services have increased much more rapidly than have the expenditures for apparel and soft goods. These changes in spending patterns have had an adverse effect upon department store sales and profits. Most department stores rely on apparel and soft goods for a very important share of their volume. Studies by Entenberg indicate that, between 1929 and 1959, department stores improved their sales position in most of these lines and were actually obtaining a larger share of the market in 1959 than in 1929.[22] Another analysis of sales changes by merchandise groups, this one by the Controllers' Congress of the National Retail Merchants Association, indicates that department stores between 1948 and 1958 improved slightly their over-all position in *department store type* merchandise. Sales volume in home furnishings declined proportionately during this period, but the sales of apparel lines increased sufficiently to more than offset this. Unfortunately, however, the apparel lines are largely the ones for which consumer expenditures have been lagging.

Thus far, little effort appears to have been made by department stores to diversify merchandise lines and perhaps not too much can be done in this respect. There is a distinct possibility, because of changes in the age distribution of the population, that consumers in the sixties will spend more of their income for apparel, and there is even some evidence that this is already taking place. If the consumer expenditure pattern of the fifties continues, however, the department store will either have to diversify to meet this pattern or obtain an increasing share of the market for existing lines. Otherwise, the relative position of the department store must continue to decline.

[22] Robert D. Entenberg, *The Changing Competitive Position of Department Stores in the United States by Merchandise Lines*, rev. ed. (Pittsburgh: University of Pittsburgh Press, 1961).

Competition from Low-Cost Retailers. New and more economical forms of retailing have been evolving almost constantly in recent years: the chain store in the twenties, the supermarket in the thirties, and the discount house in the forties and fifties. During the postwar period, the further spread of the supermarket and the rise of the discount house have pointed up the high costs and gross margins of the department store. The discount house in particular, with little service and expense ratios of 16 to 18 per cent or even lower, has taken over much of the appliance and durable goods volume of the department store. This coupled with the relative decline in consumer spending for apparel made it particularly difficult for the department store to maintain its competitive position.

The department store has been slow to adapt its operations to the new competition. Some stores have reduced the prices of appliances and have avowed their intention to compete with the discount houses. Others hold periodic warehouse sales with low prices and a minimum of service. But in general department stores have not reduced services appreciably, have not adopted the self-service and self-selection procedures of their competitors, have not effected economies in expense that would permit significantly lower markups and prices, and have not adopted pricing policies designed to achieve a large sales volume at a low unit cost. This problem of competition is a significant one, and many authorities believe that the department store must change substantially its methods of operation if it is to regain its former position in the retailing structure. It does appear that the modern consumer prefers low prices to expensive services, and low prices have been stressed by the supermarket and the discount house. It is pertinent, therefore, to turn the discussion to these two retail institutions which constitute the subject matter of the following chapter.

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11. RETAIL INSTITUTIONS (Continued)

The Supermarket

During the depression years of the early thirties, a new type of food store called the "supermarket" developed rapidly and attracted wide attention. Supermarkets were very large stores engaged primarily in the sale of food at low prices. Prior to the thirties there were large food stores in operation, particularly on the Pacific Coast and in certain large eastern cities. These were not then known as supermarkets, although they are commonly classed as such today. The stores that attracted attention in the early thirties were located in the outskirts of certain large eastern cities and were housed in abandoned warehouses and factory buildings. They were crudely equipped affairs, occupying a large space, doing a large volume of business, operating on a self-service and cash-and-carry basis, and selling foods at exceptionally low prices. They advertised widely and often used bizarre publicity devices to attract crowds. The owner of the store, quite often a wholesale grocer or a man with chain store experience, usually operated the dry grocery department and frequently the other food departments as well, and leased space to others who operated soda fountains, restaurants, and such nonfood departments as drugs, automobile accessories, and clothing. Many of these stores did a volume of business amounting to a million dollars or more per year.

This early supermarket was, to a considerable extent, a device of the independent wholesaler and retailer to meet the competition of the chain store. But chain store units had already begun to develop as general food stores during the twenties, and the self-service type of operation had been inaugurated as early as 1916 by Clarence Saunders in his Piggly Wiggly stores. Thus the general trend was already established among the chains, but the substantial competition of the new independent supermarkets greatly accelerated the trend. Beginning in the middle thirties, therefore, the chains began to

replace on a large scale their relatively small neighborhood-type grocery stores with large complete food stores which also were called supermarkets. Since that time the supermarket has developed rapidly as a retailing institution, with both independent and chain store operators. But present-day supermarkets are a far cry from the early ones. In particular, store buildings, fixtures, and equipment are modern, attractive, and inviting to the customer. Great emphasis is placed on efficiency in operation, mechanization, rapid service at the check-out counter, and approved principles of store layout. Although pricing policies are still important, there is not the emphasis on low prices that once existed. Gross margins probably average 16 to 18 per cent over-all compared with the 6 to 8 per cent obtained on dry groceries, which were featured as price leaders by the early markets. Nevertheless, the modern supermarket is a low-cost retailing institution especially in comparison with other types of retail stores, and it still has many of the characteristics of the early markets.

Characteristics of Supermarkets. Although supermarkets vary greatly, they have certain common characteristics that distinguish them from other retail institutions. First, a supermarket must carry a complete line of food products: dry groceries, meats, fresh fruits and vegetables, dairy products, and bakery products. It may or may not handle other types of goods. Most modern supermarkets do not attempt to carry the varied lines of merchandise that were sometimes sold, usually through leased departments or concessions, by the earliest markets. But, since World War II, there has been an increasing trend to stock nonfood convenience goods: drugs, toilet articles, housewares, toys, women's hosiery, and recently even gasoline and automotive accessories.[1] Supermarkets do not attempt to stock complete lines of these products but handle the faster-moving items and ones that carry a good markup. Accordingly, the sale of these products may add substantially to gross profit without a corresponding increase in expenses. A supermarket, however, to be classified as such does not have to handle these products; it must merely be a complete food store.

Secondly, a supermarket must have self-service at least in the dry grocery department. Most early supermarkets confined their self-service operation to this department, but self-service has increased greatly in recent years both in supermarkets and in other types of retail stores. Most supermarkets now have self-service operation in most, if not all, departments. Probably the last department to be converted to self-service in most markets is the fresh meat

[1] For a discussion of nonfood items in supermarkets, see M. M. Zimmerman, *The Super Market* (New York: McGraw-Hill, 1955), Chap. 11.

department. Even here it is estimated that two thirds of the supermarkets utilize self-service and prepackaging.

Third, a supermarket is a large store and it has some type of departmental organization. Most supermarkets have not carried departmentization to the point reached by department stores, but they do have some departmental organization and control. With respect to size, there is no commonly recognized standard. Prior to World War II, an annual sales volume figure of $100,000 was probably suitable, whereas at the present time the figure of $375,000 used by the *Progressive Grocer* magazine is perhaps the most widely quoted.[2] Smaller stores which otherwise have the characteristics of supermarkets—namely, self-service and a complete food line—are often called "superettes."

Importance of Supermarkets. The Census of Business does not attempt to classify and enumerate supermarkets. Consequently, there are no official statistics on their importance. The Census does, however, give information on grocery stores by size intervals, and it is possible to show the development of the supermarket from these data. In the following analysis, the size criterion of $100,000 is used for 1939 and $300,000 for 1948 and 1958. The latter figure is used rather than the $375,000 previously quoted because the Census uses it as a breaking point in its classification system.

In 1939 there were 6,221 self-service combination food stores which might properly be classified as supermarkets. These stores had total sales of $1,380 million, which constituted 3.3 per cent of total retail sales. By 1948 the number of supermarkets had increased to 12,482 with sales of more than $8,320 million, 6.5 per cent of total retail volume. In 1958 there were 27,793 grocery stores each with annual sales of $300,000 or more. A few of these probably were not properly classifiable as supermarkets, either because they did not carry a complete food line or because they did not have self-service, but the number is negligible.[3] These stores had sales of more than $28 billion, approximately 14 per cent of total retail trade. Although supermarkets constituted less than 10 per cent of all grocery stores, they obtained 65 per cent of total grocery store volume. Thus, in a period of approximately twenty years, supermarkets gained a commanding position in food retailing. As a matter of fact, their proportion of total retail sales exceeds that of department stores,

[2] The Super Market Institute, organized in 1937, used as a requirement for membership annual sales of $250,000. In 1951 this was raised to $500,000 and in 1955 to $1,000,000.

[3] Changes in methods of classification make it impossible to obtain an exact comparison between 1958 and the earlier years, but the differences are not great. Sources for the data in this paragraph are *U.S. Census of Business: 1939*, Vol. I, *Retail Trade*, Part 1, p. 817; *U.S. Census of Business: 1948*, Vol. II, *Retail Trade*, p. 15.05; and *U.S. Census of Business: 1958*, Advance Report, *Retail Trade, Sales Size*, p. 2–5.

variety stores, and mail order houses combined. Truly the supermarket is a retailing development of great significance.

Advantages of the Supermarket. The growth of the supermarket has been due largely to its methods of operation and its merchandising policies. It has the advantage of convenience of shopping, permitting the consumer to purchase all of the family's food needs at one store. Of even greater importance, the supermarket was the first retail institution to provide, as an integral part of its operation, free automobile parking space. This certainly has been a significant advantage in view of the problems created for other retailers by traffic congestion and the lack of parking space. Finally, there is the self-service method of operation. Not only did it reduce expenses and increase store efficiency in relation to the clerk-service type of operation, but it also resulted in increased sales per customer. There can be little doubt that, for many types of merchandise and especially for convenience goods, the consumer will buy a greater variety of merchandise if he is permitted access to the goods and left to his own devices. The supermarket has capitalized on this principle by stocking a wide variety of items, more than 6,000 on the average at present compared with some 800 during the twenties for the old-type grocery store, and by the use of mass display. The result has been a high average sale per transaction, high productivity per employee, low expense ratios, and low average prices. The success of the supermarket is built upon a firm foundation.

Limitations of the Supermarket. In view of the past development of the supermarket one might well wonder whether there are really any significant limitations to its future growth. Population is increasing and is expected to continue to increase. No decline is anticipated in the proportion of the consumer dollar that is spent for food. As consumer incomes and expenditures increase, per capita expenditures for food are expected to rise also.[4] There seems to be little doubt that the supermarket still has growth possibilities but there appear to be significant limitations to this growth.

In the first place, supermarkets require concentrations of population. Few supermarkets exist in areas with population concentrations of less than 10,000 persons. In 1958 there were more than 1,000 counties in the United States, almost one third of the total, which did not have a single supermarket.[5] Expansion of supermarkets is not likely to take place on a large scale in these counties, which are small in population, and thus must be confined largely to those areas which already have a large number of supermarkets. But suitable

[4] See William Applebaum and David Carson, "Supermarkets Face the Future," *Harvard Business Review*, March–April 1957, esp. pp. 125–7.

[5] According to "Super Market Land" published by the *American Weekly*.

locations in the larger cities are already becoming difficult to obtain, and each new market that is opened not only reduces the number of available locations but provides increasing competition for existing markets. Already small grocery stores, those with annual sales of less than $75,000, have been reduced to 7 per cent of the total grocery store market, which is certainly close to the irreducible minimum.[6] One possibility for further supermarket expansion, of course, is the growth of the smaller superettes into full-fledged supermarkets.

A second problem of the supermarket is rising costs which are leading to a "cost-price squeeze."[7] Increasing competition among supermarkets themselves has led to more expensive store buildings and equipment, longer store hours and increased labor expense, and higher promotional and advertising costs. Although the supermarket originated as a low-cost, low-price operation, the pressure of competition has led to a "trading-up" effect. In particular there is the necessity for constant modernization of building, fixtures, and equipment, thus an increasing investment in facilities.[8] Because of the low net profit rates of supermarkets, from 1 to 3 per cent of net sales, financing for modernization is not always easy to obtain. Costs have risen steadily in response to competitive pressures. The increase in number of items stocked has required more space. Longer store hours have resulted in higher labor and operating costs. Expenditures for promotional purposes—for example, more than 35 per cent of all supermarkets gave trading stamps in 1959—have also increased in many instances: As yet these increased costs have probably not restricted the development of the supermarket to any great extent, but they have been instrumental in the decisions of operators to stock nonfood items with high margins and in some instances to place more emphasis upon private brands. Further increases in costs might prove to be a deterrent to supermarket expansion.

The supermarket is also beginning to have personnel problems somewhat similar to those of the department store. Insufficient attention has been paid to the development of executives, and a shortage of trained personnel of this type is expected in the future. Wage rates for regular personnel have been advancing and are above those of most other retail establishments. Nor is labor productivity expected to rise as rapidly as wage rates in the near future.

[6] "Facts in Grocery Distribution," 1960 edition, *Progressive Grocer*, April 1960, pp. F7–F9.

[7] Gross margins are now said to average 20 per cent compared with 17 a decade ago. See "Not Much More Room To Grow," *Business Week*, June 4, 1960, p. 45.

[8] It has been said that there are few supermarkets more than five years old that have not been remodeled or abandoned. E. A. Brand, "Supermarkets and the Changing Times," in Robert D. Buzzell (ed.), *Adaptive Behavior in Marketing* (Chicago: American Marketing Association, 1957), p. 2.

To make the personnel situation even more difficult, greater and greater use is being made of part-time employees,[9] which means that new problems are arising with respect to training and employee incentives, and that labor turnover rates are increasing.

Thus there are limitations to the future development of the supermarket. At present it is not clear exactly how significant these limitations will be. The industry is still growing although the rate of growth has been declining since 1956. Most authorities expect this trend to continue for several years. In any event, the supermarket has reached maturity as a retail institution. External factors, such as population growth and consumer expenditure patterns, will be important in its future development; but management must be alert in the future, as it appears to have been in the past, to adapt to changing conditions as they arise.

The Discount House

Although the rise of the discount house as a retail institution is usually associated with the period following World War II, neither discount selling nor even the discount house are particularly new phenomena. There were a number of discount houses in New York during the thirties, including one which was operating as early as 1914.[10] It was estimated in a study made in 1937 and 1938 that discount sales in the Boston area amounted to 1.5 to 2 per cent of total retail sales, or 5 to 7 per cent of sales of the types of goods usually subject to discounting.[11] And by 1943 there were approximately 200 discount houses in New York.[12]

The discount house, therefore, appears to have had its origin in the depressed thirties when consumers were especially receptive to any retail institution that would sell merchandise at reduced prices. It was also during this period that most states passed the so-called "fair trade" laws which permitted the manufacturer to establish the resale price of a branded product and thus restricted price competition among regular retailers.[13] Most manufacturers established prices which gave retailers rather generous gross margins —in the household appliance field from 33 to 40 per cent. Some manufacturers

[9] Over 40 per cent of all supermarket personnel now consist of part-time employees. See William Applebaum and David Carson, *op cit.*, p. 132.

[10] Ralph S. Alexander and Richard M. Hill, "What To Do About the Discount House," *Harvard Business Review*, January–February 1955, p. 53.

[11] Gerald B. Tallman, "When Consumers Buy at Wholesale," *Harvard Business Review*, Spring 1939, p. 341.

[12] Frances M. Lehman, "The Discount House," *Journal of Retailing*, February 1943, p. 24.

[13] The fair trade, or resale price maintenance, laws are discussed in Chap. 28.

who established resale prices for dealers did not invoke the price maintenance laws and some who did invoke them were lax in enforcement. The discount seller, therefore, quickly seized the opportunity to sell these price-maintained products at a discount to selected groups of customers—the employees of a large nearby manufacturing firm, members of a labor union, government employees, school teachers, and similar groups. Discount prices thus were not openly offered and advertised, and admission to the discount house was usually by identification card.

The advent of World War II interrupted the normal development of the discount house because of the shortage of merchandise, a shortage that was particularly prevalent in the products most adaptable to a discount operation. But with the resumption of the production of consumer durable goods on a large scale in the late forties and early fifties, the discount house flourished. This period was one of substantial competition for volume on the part of manufacturers. Discount houses could supply this volume and it was not difficult for them to obtain supplies. Regular distributors and dealers with overstocks were usually glad to sell in volume to the discount houses at regular wholesale prices or at a small markup over cost. And the manufacturer, although his regular distribution channels were being violated and his regular dealers injured, was obtaining the desired volume and in most cases was reluctant to interfere. Moreover, the fair trade laws began to break down. More and more state laws were being held unconstitutional, especially in the fifties, and more and more manufacturers removed their products from the protection of these laws even in the states in which they continued to exist. Thus discount houses began to operate openly, to advertise, and to solicit patronage from all consumers rather than from special groups.

The present discount house then must be classified as a major regular retail institution. It has developed basically for two reasons. First, consumers were willing to have certain services eliminated in return for lower prices. Secondly, retailers in many instances, especially immediately after World War II, were charging prices in excess of the value of the services actually being performed. The development of the discount house then gave consumers greater freedom of choice, enabling them to purchase items without service if they so desired. Also it forced the regular retailers to examine their operations and to bring their prices and margins more in line with the actual costs incurred and services performed.

Characteristics of Discount Houses. Although discount houses vary greatly as to methods of operation and other characteristics, they are distinguished by one common feature: the sale of merchandise at a discount "from the

manufacturer's listed retail price or from the price at which other types of retailers sell or purport to sell."[14] All retailers who discount are not necessarily discount houses, however. Although regular automobile dealers do a great deal of discounting of the prices of new automobiles, they are not usually considered to be discount houses.[15] The distinction is that the discount house has a regular and consistent policy of selling below the list price and treats all customers in much the same way. There is no camouflage of operating through an inflated trade-in allowance or through some other price-cutting device. Most modern discount houses have the discount price, and usually the list price, marked on the merchandise. Individual bargaining on price between the store and the customer is likely to be no more prevalent in the discount house than it is in many other types of retail stores.

Discount houses handle many different types of merchandise but in general they concentrate on specialty goods and avoid convenience goods. Household appliances, typewriters, photographic equipment, sporting goods, pens and pencils, furniture and house furnishings, jewelry, and silverware are the traditional products sold by discount houses. More recently, many of the larger discount houses have added soft goods, that is, clothing and apparel lines. In general, the discount house concentrates on well-known national brands in order to capitalize on the sales efforts of the manufacturers and point up to the consumer the amount of the price differential. They also stress merchandise with a high unit price.

The third characteristic of the discount house is that it is essentially a nonservice store.[16] Merchandise stocks are limited and many items are sold by special order. Selling service is provided and salespeople are often reported to be well trained and helpful, but self-selection procedures are utilized effectively. Credit is not normally extended through open charge accounts, and an extra charge is made for the delivery of bulky merchandise. Installation and repair service are not usually provided. If the product fails to perform satisfactorily within the warranty period, the buyer must take up the matter directly with the manufacturer's authorized distributor or service station. Many of the services rendered by other stores, such as check cashing, gift wrapping, C.O.D. shipments, and telephone orders are either not offered at all or are definitely discouraged. This lack of service, of course, constitutes the basic reason why discount houses can sell at low prices.

[14] Ralph S. Alexander and Richard M. Hill, *op.cit.*, p. 54.

[15] It was reported near the end of 1958 that most automobile dealers were selling about 12 per cent below the posted price. *Business Week*, December 20, 1958, p. 25.

[16] For an account of the specific services offered by some discount houses, see Claire M. Gross, "Services Offered by Discount Houses in Metropolitan New York," *Journal of Retailing*, Spring 1956, pp. 1–13.

Importance of Discount Houses. It is not possible to determine even approximately the importance of discount houses at the present time. It was estimated that for the Los Angeles area in 1952 at least 25 per cent of major appliances were being sold at discount prices.[17] By 1954 trade paper reporters placed the figure at 55 to 70 per cent. It was estimated in the same year that there were 6,000 to 10,000 discount houses in the United States with annual sales of $5 billion.[18] Another 1954 estimate placed the sales figure of discount houses at $25 billion, or 18 per cent of total retail trade.[19] No doubt some of the difference in these estimates is accounted for by differences in the definition of a discount house and perhaps by a failure to distinguish between discount selling generally and sales by discount houses as such. Nevertheless, it is evident that the growth of the discount house was one of the very important trends in retail distribution during the fifties.

Advantages of the Discount House. The growth of the discount house is based on its ability to sell merchandise at lower prices than those charged by competitive retailers. In order to do this consistently, it must operate economically and with low costs. The discount house does appear to have a substantial cost advantage in relation to its principal competitors. Some of the major houses have claimed in the past expense ratios of 10 to 12 per cent of sales.[20] At present it is generally assumed that expenses amount to 15 to 18 per cent of sales, substantially lower than the ratios of 33 to 34 per cent generally required by department stores. It has already been noted that discount houses do not offer many of the services ordinarily associated with the retailing of consumer durables, and this is the principal source of the economies effected by discounters. In addition, sales per employee are considerably higher in discount houses than in most of the competitive forms of retailing, especially department stores. Finally, there is usually a more efficient utilization of selling space, since discount houses ordinarily operate with limited space in relation to the volume of sales and also often utilize low-rent locations.

Limitations of the Discount House. Although the discount house has grown rapidly in importance as a retail institution and will undoubtedly con-

[17] F. W. Gilchrist, "The Discount House," *Journal of Marketing*, January 1953, p. 270.

[18] Herbert Brean, "Discount Houses Stir Up a $5 Billion Fuss," in Malcolm P. McNair and Harry L. Hansen, *Readings in Marketing*, 2nd ed. (New York: McGraw-Hill, 1956), pp. 345–55, reprinted from *Life*, August 9, 1954.

[19] The estimate was made by the Chamber of Commerce of the United States and quoted by Arnold Corbin, "The Economics of Discount Selling," in John W. Wingate and Arnold Corbin (eds.), *Changing Patterns in Retailing* (Homewood, Ill.: Irwin, 1956), pp. 126–7, reprinted from the *New York Retailer*, March 1955.

[20] See Arnold Corbin, *op.cit.*, p. 129, for a breakdown of the expenses of one house as of the early fifties.

tinue to increase in importance, there are some limitations to its future growth. In the first place, the discount house is subject to the same type of trading-up effect that has already been noted in the case of supermarkets. For some time, there has been a trend away from upstairs low-rent locations. In New York, the majority of discount houses are now found in high-rent areas with heavy customer traffic,[21] and this is also the trend in other large cities. More money is also being spent on attractive exterior signs and on advertising and promotion. Thus costs are rising and part of the price advantage of the discount house must necessarily be lost.

Secondly, the discount house is being faced with constantly increasing competition from other retailers, especially the department store. Many of the latter are now openly advertising discount prices on appliances and offering to meet any price that the customer can obtain elsewhere. A number of department stores are holding periodic "warehouse sales" at which discount merchandise is sold at the warehouse, often with a minimum of service, at prices that compare very favorably with those of discount houses. Regular appliance dealers are also becoming more and more aggressive in promoting discount prices and special sales. The principal problem that these competitive retailers face is whether they can reduce their costs sufficiently to make these sales profitably. If the department store and appliance dealer continue to operate on a service basis with the higher costs that are incurred by such operation, it will be difficult to sell profitably at nonservice prices. But if services and costs are reduced and if costs are appraised more accurately and realistically, these retailers will be in a position to furnish substantial competition to the discount house.

A third factor which may limit the future growth of the discount house is the increasing freedom to compete that is being accorded to regular distributors and dealers. As has been previously noted, the fair trade laws are no longer so effective as they once were, and regular dealers are now more likely to be able to reduce prices without fear of legal action by manufacturers. Moreover, a few manufacturers are reducing prices and marketing margins so that the difference between regular prices and discount prices is no longer so pronounced.[22] If this trend continues, the prices of discount houses will be less attractive to the consumer than they have been.

[21] Claire M. Gross, *op.cit.*, p. 4.

[22] At the end of 1955, the General Electric Company reduced distributors' and dealers' gross margins on small appliances and established lower recommended retail prices. Previously the company had turned over to its wholesale distributors the responsibility for setting retail prices on major appliances, thus permitting each distributor to adjust to the price situation in his area. Both moves would appear to be attempts to help dealers meet the problem of discount pricing. See further discussion in Chap. 28.

Finally, it should be noted that most discount houses are faced with the same problems of traffic congestion and lack of parking space for customers that afflict other retailers in downtown locations. Discounters, of course, can move to the suburbs, and there is some tendency for them to do so. But the nonservice character of the discount house is so firmly established that only a few of the largest have made any attempt to provide parking space. When they do, it may be presumed that higher costs of operation will result.

Conclusions

The rapid changes that have taken place in the retailing structure and in retailing institutions since World War II have been designated as the "retailing revolution" and no doubt justifiably so. But in many respects the changes have been evolutionary rather than revolutionary. Retailing has always been a very dynamic part of the marketing system of the United States, and change has been the rule rather than the exception ever since the single-line store began to replace the general store. The single-line store has given ground in turn to scrambled merchandise lines and large-scale forms. In a certain sense, retail institutions appear to be reverting to the general store philosophy. The constant expansion of product lines and the resulting overlapping of merchandise offerings makes it more and more difficult to classify retailers by institutional type. The larger discount houses are often similar to department stores except for the lack of emphasis on service, and many supermarkets resemble general stores except in size and degree of departmentization.

Retail institutions in the United States seem to follow a rather specific evolutionary pattern. A new type of institution originates, somewhat similar to existing types, but with a substantial emphasis on new and less expensive methods of operation and on low prices. On the basis of the price appeal, an early clientele is easily attracted. The success of the innovators attracts competitors who establish like types of operation. Moreover, the older institutions attempt to adjust their operations in order to compete more successfully. As competition increases generally, the price appeal loses some of its effectiveness and the trading-up process begins. Services are added, modern buildings are utilized, better and more costly locations are found, and expenses gradually increase. This adjustment continues until some level of competitive equilibrium is reached, generally a level at which costs and prices are lower than they were in the older retail institutions but higher than they were in the new institution at the time of origination. If the trading-up process and the competition in service gets out of hand, as it apparently did in the

case of the department store, a new institution develops and a new cycle of change begins.

At the present stage of the evolutionary process, the old type of general store has been almost completely eliminated, a victim of social change as well as of new retailing institutions. The department store and many of the limited-line stores represent the older and higher-cost forms which are attempting to adjust not only to social change but also to the competition of new institutions, the supermarket and the discount house. But the supermarket has already traded up to a considerable extent and the discount house is following in its steps. Rising costs are leading the supermarket into the higher-margin nonfood products, and it is probably for the same reason that discount houses are expanding into soft goods. Extreme diversification of lines may well result in still higher costs. Whether the supermarket and discount house will follow the pattern set by the department store is not yet clear, but, if they do, it is likely that new institutions will arise to furnish competition for the old.

CASE PROBLEM—THE CORNER DRUG STORE

The Corner Drug Store is located in the downtown shopping district of a city of 25,000 population. It is a well-established store, having been operated under the present name for about forty years and by the present owner for ten years. It is one of the three largest drug stores in the community with a sales volume of $175,000 per year, about one third of which is made on open account credit. Of the ten drug stores in the city, eight are located in the main business district. These stores are essentially alike in their methods of operation, handling similar assortments of merchandise at similar prices. All are independently owned and operated, although the largest store has a franchise arrangement with the Rexall Drug Company and handles a large number of Rexall brands—along with other brands, of course.

The Corner Drug Store has been approached by a fixture company with the idea that it should convert to self-service. Since no other drug store in the community is using self-service, it is argued that the Corner Drug Store could increase its sales volume substantially by converting. The representative of the fixture company states that one third of the nation's drug stores are using self-service and the average increase in volume upon conversion is from 25 to 30 per cent, with individual stores often reporting increases of more than 40 per cent. Reports in trade journals generally substantiate these figures, although some stores, of course, have failed to realize significant gains upon conversion.

At the present time, the Corner Drug Store employs one registered pharmacist in addition to the owner, five salespeople, a bookkeeper, and a pricing clerk. It is not anticipated that conversion to self-service will reduce significantly the number of employees required. In the first place, there are a number of products for which self-service is not appropriate: prescription drugs, personal products,

and such items as cosmetics and photographic equipment which require the services of a salesperson to give advice and sales points. In addition, it is expected that many customers will require assistance in locating wanted items. On the other hand, it is anticipated that peak traffic loads will be handled more rapidly under self-service and with less customer waiting.

One of the problems of the Corner Drug Store is that it has only 5,000 square feet of floor space, of which 3,700 is selling space, whereas the minimum usually recommended for a self-service operation is from 5,500 to 7,500.* The representative of the fixtures company, however, states that he knows of several self-service operators who are doing well with only 4,000 square feet of space. However, a certain amount of remodeling will be necessary if conversion is effected, some new fixtures will be required, and new equipment—such as cash registers—will have to be purchased. It is estimated that the cost of conversion will amount to approximately $25,000.

What are the advantages and disadvantages of converting the Corner Drug Store to a self-service operation? What should the proprietor's decision be? If the decision is made to convert, what changes, if any, should be made in the merchandise assortment policy and in the price policy of the Corner Drug Store?

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12. THE OWNERSHIP AND CONTROL OF RETAIL ESTABLISHMENTS

On the basis of ownership and control, the primary distinction to be made is that between the independent retailer and the corporate chain. Many independents, however, in order to meet the competition of the chains, have banded together into organizations designated as "contract chains." In these organizations, groups of independent retailers engage in numerous joint activities, such as buying, advertising, and sales promotion. The objective is to achieve the economies and efficiency of the chain store system without the loss of individual freedom of action. There are two basic types of contract chain: the voluntary group and the retailer-cooperative group. In addition, there is a fourth form of retail ownership and control, the consumer cooperative. This is an establishment owned and operated by the consumers who patronize it. Although of minor importance in the retailing system of the United States, it represents a distinct form of marketing organization and is of considerable importance in a number of other countries. These four types of retail organization will constitute the subject matter of this chapter.

THE INDEPENDENT RETAILER

Most retail establishments are independently operated and controlled. In the United States in 1958, some 90 per cent of all establishments doing 66 per cent of total retail sales volume consisted of single-unit operations.[1] Except for a few consumer cooperatives and perhaps a limited number of stores of other types, all of these single units were operated as independents.

[1] Computed from data in the *U.S. Census of Business: 1958*, Advance Report, *Retail Trade, Sales Size* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1960), p. 2–2.

In addition, there were a certain number of the smaller multiunit firms which undoubtedly were operated in the manner of independents rather than as chain store systems.

Although independent retailers are of all types and sizes, it is evident from previous discussions that most of them are small and most of them operate limited-line stores. Accordingly they have the advantages and disadvantages of small-scale operators and of limited-line retailers, which have been discussed in Chapters 9 and 10. In comparison with chain store systems specifically, independents have two principal advantages: (1) flexibility and freedom of action and (2) the incentive of personal ownership. The independent retailer is in a better position to adapt his operations to local conditions than is the manager of a chain unit. Decisions can be made without waiting for permission from headquarters, and there are no conflicting central office policies to prevent appropriate action. Products and brands can be stocked which are in demand in the local community without regard to whether it is the policy of headquarters to handle particular items. Moreover, the independent merchant has every incentive to make these and other decisions promptly and wisely since he is the one who obtains the profit or suffers the loss. That these advantages are not insignificant is shown by the fact that chain store systems for many years have tended to give their local managers more and more autonomy, especially in buying, and have established profit-sharing compensation plans to provide management incentive.

The disadvantages of the independent retailer are largely those of small size and lack of specialization in management, points that have been previously discussed. Even the large independent is not likely to have the buying power of the chain or an equal amount of specialized managerial personnel. Of even greater importance, the small independent often does not have the knowledge of business to operate efficiently. This was particularly true in the days of rapid development of chain store systems when the foundation of their success often lay in the inefficiency of independent merchants. Since that time, a great deal of effort has been devoted to improving the managerial efficiency of the independent. Information and advice on business methods and operations are available from manufacturers, wholesalers, contract chain headquarters, collegiate schools of business, and the federal government. Much has been accomplished in making the independent merchant a more efficient businessman, and he is in general an effective competitor of the chain. In fact, independents as a whole have not lost ground to the chains during the last three decades. But they have lost ground in some merchandise categories,

the competition in many lines is intense, and the independent cannot afford to become complaisant—although the chains have their problems also as will be seen in the following section.

THE CORPORATE CHAIN

A chain store system consists of a number of retail stores which sell similar products, are centrally owned, and are operated under one management. Although there are exceptions, such as the ownership group type of department store chain previously discussed, most chains have central buying for all stores and centralized control of store design and operation, advertising, and personnel policies. Merchandise is often supplied to all unit stores from warehouse distribution centers.

The existence of a separate central office or administrative unit is normally conclusive evidence that the organization is that of a chain. Branch store organizations rely on a parent store to serve the branches rather than on a central administrative unit serving and controlling all stores. Large chain store systems have numerous administrative units at district and divisional levels as well as the principal central office at national level. One of the problems of such an organization, of course, is to achieve proper coordination and delegation of authority and responsibility at these various management levels.[2]

No specific number of store units is necessary for an organization to be defined as a chain store system; the controlling factor is whether it has central ownership and operation. However, organizations with only a few units are less likely to have central offices than are those with a greater number. Accordingly, the Census of Business prior to 1948 required that a multiunit organization have at least four stores to be classified as a chain. Since 1948 the Census has not specified any particular number of units, although there has been a tendency in the trade press to use eleven units as the dividing line. In the discussion here, the four unit requirement will be used generally in order to achieve maximum comparability of data.

Development and Present Importance

Although the chain method of operation has been in existence for centuries, the chain store as we know it today made its appearance in the United States in 1859 with the establishment of the second unit of the Great At-

[2] For suggested solutions at the divisional level, see Edgar A. Pessemier, "Division Organization in Food Chains," *Journal of Retailing*, Winter 1957–58, pp. 170–81.

lantic & Pacific Tea Company.[3] In the following half century, many other chains were started including the F. W. Woolworth Company in 1879, Kroger Grocery & Baking Company in 1882, S. H. Kress & Company in 1896, S. S. Kresge & Company in 1897, and the National Tea Company in 1899. The volume of business of these and other firms grew at a fair rate until 1900. It increased more rapidly from 1900 to 1920 and tremendously from 1920 to 1930. During this latter decade, the rise of the chain store was probably the most significant development in marketing, certainly the most significant in retailing. The number of chain store organizations and units increased rapidly during the period, and the proportion of total retail sales volume obtained by the chains rose from less than 5 per cent at the beginning of the period to more than 20 per cent at the end of it. Expansion took place in virtually all retail lines but was of particular importance in the food field.

Since 1930 the relative sales volume of the chains has tended to level off at least until the mid-fifties. Although census data are available for 1929 and other years with respect to chain store units and sales, there have been several changes in the methods of enumeration and in the handling of multiunit classifications. Thus exact comparisons are impossible to make. According to the census figures, 23.7 per cent of total retail volume was obtained in 1954 by multiunit organizations with four or more establishments, and 26.8 per cent in 1958.[4] The figures reported for previous census years are as follows: 22.8 for 1948, 21.7 for 1939, 23.3 for 1935, and 20.3 for 1929. Actually, the ratios for these earlier years are probably understated in relation to those of 1954 and 1958, but the 1958 figure does appear to indicate a significant gain for the chains. Whether it represents the beginning of a new trend cannot be determined at present.

Interesting changes have also taken place in the number of chain store units. In 1929 there were more than 151,000 chain units, amounting to 10.3 per cent of total retail establishments. With the development of the supermarket during the thirties and the resulting tendency of food chain organizations to replace several small stores with one large supermarket, chain store units by 1939 had declined to approximately 123,000 or 7 per cent of total establishments.[5] In 1958 there were some 114,000 chain store units constitut-

[3] This date is commonly used, but the exact date is uncertain. See Roy J. Bullock, "The Early History of the Great Atlantic & Pacific Tea Company," *Harvard Business Review*, April 1933, Part I, pp. 289–98. He also mentions an earlier chain that began operation in New York City in 1855 but which no longer exists.

[4] See *U.S. Census of Business: 1954*, Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 19. The 1958 figure is computed from data in the *U.S. Census of Business: 1958*, Advance Report, *Retail Trade, Single Units and Multiunits*, 1960, p. 4–2.

[5] Not all of the decrease in chain store establishments took place in the food field; other kinds of business were involved also. But the case of the Great Atlantic & Pacific

ing 6.4 per cent of all retail establishments. Since the figures for 1948 and 1954 are about the same as those for 1958, it is likely that the trend toward retrenchment of units has about come to an end.

Importance of Chains by Kind of Business. Some kinds of retail business appear to be much better adapted to the chain store type of operation than are others. Thus chain units in 1954 obtained almost 80 per cent of the total sales volume of all variety stores and 66 per cent of total department store sales. But in the automotive group only 3 per cent of the sales volume was obtained by chain units. The data for selected kinds of business are shown in Table 12-1. Although grocery stores rank third in proportion of sales ob-

TABLE 12-1

Proportion of Chain Store[a] Sales to Total Retail Sales for Selected Kinds of Business, United States, 1954

Kind of Business	*Per Cent of Chain Store Sales to Total Retail Sales*
Variety Stores	79.7
Department Stores	65.9
Grocery Stores	43.4
Apparel and Accessories Stores	28.9
Liquor Stores	28.4
Drug Stores and Proprietary Stores	19.8
Jewelry Stores	13.4
Furniture, Home Furnishings, and Appliance Dealers	13.1
Lumber, Building Materials, Hardware, and Farm Equipment Dealers	11.8
Gasoline Service Stations	8.1
Eating and Drinking Places	7.6
Automotive Group	3.2
Total Retail Trade	**23.7**

[a] Multiunit organizations with four or more establishments.

Source: U.S. Census of Business: 1954, Vol. I, *Retail Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 19.

tained by chains, it might be noted here that chain grocery stores have the highest total dollar volume of any single type of chain operation. Of the

Tea Company illustrates what did happen in that field. A & P operated 5,217 units in 1922 and 15,737 in 1931. Although official figures are not available for the interim years, it probably eliminated about 5,000 stores between 1936 and 1941. As of 1958 A & P operated some 4,200 units of which 150 were located in Canada.

$40 billion of chain store sales made in 1954, grocery chains obtained almost $15 billion, or some 37 per cent of the total.

Although the over-all proportion of chain store sales to total retail sales did not change greatly between 1929 and 1954, there were many changes within the various kinds of business. Some of these changes are shown in Table 12-2. Although the data are not completely comparable from one year to another, they are sufficiently so to show the basic trends. Thus variety stores and furniture stores have shown a slight decline in the relative importance of the chain, and gasoline service stations have shown a significant

TABLE 12-2

Proportion of Chain Store[a] Sales to Total Retail Sales for Selected Kinds of Business, United States, Selected Years

Kind of Business	*Proportion of Chain Store Sales to Total Retail Sales* 1929	1939	1948	1954
Variety Stores	90	87	83	80
Department Stores[b]	28	42	52	66
Grocery Stores:				
With Fresh Meat	32	38	41	43
Without Fresh Meat	46	32	21	
Shoe Stores	38	56	48	46
Women's Ready-To-Wear Stores	23	28	29	31
Liquor Stores	—	46	31	28
Jewelry Stores	6	10	11	13
Furniture Stores	14	15	12	11
Hardware Stores[c]	3	4	16	13
Gasoline Service Stations	34	10	7	8
Eating Places	14	14	11	12

[a] Multiunit organizations with four or more establishments.

[b] The data for department stores are not very comparable. In 1954 the ownership group type of department store was included as a multiunit organization for the first time, and mail order houses of the department store type were excluded. Adjustment of the 1948 percentage for the two changes is estimated to give a figure between 62 and 66. The percentages for 1929 and 1939, according to the Census, are probably overstated in relation to the 1948 percentage, and adjusted figures may not be much above those given.

[c] Changes in the classification of hardware stores account for the greater part of the increase between 1939 and 1948.

Source: Data for 1929, 1939, 1948 from *U.S. Census of Business, 1948*, Vol. I, *Retail Trade*, Part 1 (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1952), p. 18. Data for 1954 are from Table 12-1 when available there; otherwise computed by the writers from data in Table 4A of Vol. I of the 1954 Census, *op.cit.*

decrease. This latter is a result of the policy of refiners during the thirties to lease company-owned stations to independent operators. The importance of the chain in department store operations, on the other hand, increased substantially between 1929 and 1948 (see note b in connection with the table). Trends with respect to other kinds of business may be noted in the table.[6]

Importance of the Large Firms. One of the striking characteristics of the chain store field is the large size to which some of the individual organizations have grown. Although there are several thousand chain organizations in the United States,[7] the twenty largest appear to do almost 50 per cent or more of total chain store volume.[8] In the food field, the fifteen largest chains—eleven of which rank in the top twenty in sales volume among all chains—in 1958 obtained 30 per cent of total food store sales, both chain and independent.[9] There are six chain store organizations each of which in 1959 had a sales volume in excess of one billion dollars. They are Montgomery Ward with $1.2 billion, J. C. Penney with $1.4 billion, Kroger with $1.9 billion, Safeway with $2.4 billion, Sears, Roebuck with $4.0 billion, and A & P with $5.1 billion. The latter organization alone has about 2.5 per cent of the total retail sales volume of the nation (10 per cent of total food store volume), and the six together obtain about 7.5 per cent.

Conditions Favoring Chain Development. Chain store systems, especially in the food field, developed rapidly during the twenties because they adopted a new philosophy of retailing. Prior to that time, chain operations were perhaps not greatly different from those of independents. Convenience goods stores in general were not operated with great efficiency. Costs were high, all the standard services were offered to consumers, and the prices charged reflected both the inefficiency of operation and the cost of services.

Then certain chain operators began to experiment with cash-and-carry methods and the appeal of low prices.[10] They were so successful that these

[6] Since the figures for grocery stores are not easily interpreted in the table, it may be mentioned that grocery chains with 11 or more establishments increased their share of total grocery store sales from 35 per cent in 1948 to 43 per cent in 1958. *Economic Inquiry into Food Marketing*, Part I, *Concentration and Integration in Retailing* (Washington, D.C.: Staff Report to the Federal Trade Commission, January 1960), p. 2.

[7] Specifically in 1948, the Census enumerated 6,159 firms operating four or more units.

[8] In 1959 total retail sales amounted to $215 billion, according to the *Annual Retail Trade Report*: 1959 (Washington, D.C.: Bureau of the Census, June 1960). If chain store sales are estimated at 24 per cent of total (the 1954 census figure was 23.7), chain sales would have amounted to $51.6 billion. The twenty largest chains in 1959 had total estimated sales of $25.2 billion or 49 per cent of total chain store sales. See *Business Week*, April 23, 1960, p. 43.

[9] FTC Food Marketing Inquiry, *op.cit.* in note 6, p. 76.

[10] Henry Kohls of Jersey City in 1908 was the first, or one of the first, to operate successfully on a cash-and-carry basis. See Paul D. Converse, "Twenty-Five Years of Wholesaling: A Revolution in Food Wholesaling," *Journal of Marketing*, July 1957, p. 45. Self-service operation also was inaugurated prior to 1920 by some chains, but it

policies soon became the distinguishing characteristics of the chain store. In addition, the chains were able to buy directly from manufacturers and to perform the wholesaling functions more economically than did the independent wholesalers. Finally, they improved efficiency and reduced operating costs.

The independent merchant did not adjust immediately to the new competition of the chain. He believed that services must be maintained, and he could not buy as advantageously as could the chain. Neither did he know just how to go about improving the efficiency of his operation. A number of efforts were made, especially in smaller communities, to create a popular prejudice against the chains. "Keep your money at home" and "patronize local merchants" were popular slogans of the independents, but they were largely ineffective in impeding the development of the chains. The result was that the chains were able to grow rapidly during the twenties and attain an important place in the retailing system.

Advantages of the Chain

The success of most chain store systems is based largely upon the appeal of low prices. The extent to which chain store prices are actually lower than those of the more efficient independents is not known, but most studies that have been made—and they have been mainly concerned with the food field—indicate that chain prices are below those of independents generally. This is probably more true for the large national chains, however, than it is for sectional or local chains.[11] In any event, the price advantage of the chain, to the extent that it exists, is likely to be based largely upon its buying power and low operating cost ratios. One important reason for low operating costs is certainly the lack of emphasis on service. Cash-and-carry operation, however, is a policy that happened to be adopted by the chains and may be used by any retail enterprise. And many of the other advantages of the chain are equally available, or almost so, to other large-scale firms. Thus the major advantages of the chain are the advantages generally of large-scale retailing—superior management, effective buying and sales promotion, and economics achieved through integration. The chain store system, however, has one particular advantage of its own. This is its ability to use standardized methods of operation.

was not used on a large scale until the advent of the supermarket in the thirties. See Chap. 11.

[11] See, for example, Werner Z. Hirsch, "Grocery Chain Store Prices—A Case Study," *Journal of Marketing*, July 1956, pp. 9–23.

Standardized Methods of Operation. Because of its multiunit character, the chain can make particularly effective use of specialists and experts. The best way of doing things can be determined by these experts and utilized by each store. Specialized management services are made available by the central office, and store managers are relieved of many administrative activities which the independent merchant must perform. Thus in most chains there is uniformity in store building and design, in layout and display, in advertising, in selecting and training personnel, and in store service and selling policies. The result is that a highly efficient operation is obtained at a lower cost than would be possible otherwise.

Because these various activities are carried out by specialists they can be well planned, and because control is centralized they can be uniformly executed. In fact, many of the advances in modern retailing, such as the improved selection and display of goods and the improved appearance of the ordinary retail store, trace their origin to the pioneering work of the chains. High administrative expense and the high salaries that must be paid to the specialists tend to offset in part these advantages, but when the expense is spread over a large volume of business, the more effective and more economical operations that result are likely to be obtained at a relatively low cost. This is the particular advantage that a chain store unit has in relation to an independent merchant.

Factors Limiting Chain Store Expansion

During the twenties, as previously mentioned, chain store expansion was so rapid that it overshadowed all other developments in the field of retailing. Since that time, however, there has been little, if any, over-all increase in the proportion of retail sales volume obtained by the chains. Some of the influences which operated to check this rapid expansion were inherent in the chain methods of operation; others were the result of the vigorous efforts made by independent merchants to combat the chain. Regardless of the source, there are important limitations to the further expansion of the chain.

Personnel Limitations. As with other large-scale organizations, one of the chief problems of the chain is that of personnel. Neither the store employees nor the store managers have that direct personal interest in the store and its customers that is found in the successful independent. In the case of chains operating throughout large sections of the country, this problem is even more important than it is to the department store or mail order house, in which personnel can be more closely supervised. To train and to furnish adequate incentives to hired managers to operate stores effectively is a prob-

lem which is far from solved. Much has been done through executive training programs, profit-sharing plans, decentralized supervision, and other methods. But the fact remains that the hired manager often is not so efficient as the same man would be in his own store, and the supervisory problem is made more difficult in the chain because of the necessary separation of the store manager and other personnel from top management in the central office. Furthermore, when a good manager is developed, he often quits the chain to enter business for himself.

Standardized Methods. Store buildings, equipment, services, and merchandise all tend to be standardized throughout the units of a chain. Such standardization permits the effective use of specialists and central management and results in definite economies. But it also makes for a degree of inflexibility which in turn makes adaptation to local conditions difficult and sometimes impossible. The greatest handicaps probably arise out of the standardization of merchandise and of price. Local managers of chain units may be unable to stock some items which are definitely in demand in a local area. Even if they are allowed some discretion in choosing from approved lists, the items available may be too limited to meet their needs. And in areas in which price competition is intense, it may be very difficult for the local manager to obtain authority promptly with respect to a price reduction.

The result has been an increasing tendency to delegate more authority to the local manager, especially with respect to buying. This is particularly true of chains that handle shopping goods. Although the standard items and sources of supply are to be used in the majority of cases, the manager is permitted to stock other items when necessary and to obtain emergency supplies from other sources. In some chains, such as the department store ownership groups, the central buying office serves mainly as a source of information as to what is available in the market, and the local buyers have virtually complete autonomy with respect to purchases. In such cases, of course, much of the buying advantage of the chain type of operation is lost.

Rising Costs. As the size of an organization increases, it tends to reach, and then to pass, the point of optimum efficiency. From that point on, further expansion is likely to result in a disproportionate rise in operating costs. As chain organizations spread into small towns and outlying districts of the larger cities, the cost of supervision may increase, the cost of delivering merchandise from the central warehouse to the retail store may rise, and the volume of business per store is not likely to be so large as in the case of units located in more densely populated areas. Furthermore, there is a potential danger of too rapid expansion and a consequent lack of adequate control.

Of perhaps even greater importance, there has definitely been a tendency

on the part of the chains to trade up their operations. As competition has become greater, they have sought better and more costly locations, have built new and attractive but more expensive buildings, have added new types of equipment and furnishings, and in other ways have sought to make their stores more attractive shopping places for consumers. As a result expense ratios have risen and the price advantage of the chains, while still a definite factor in their favor, has undoubtedly been reduced. Thus the chain store, as a retail institution, is in that stage of the evolutionary process described in the previous chapter in which competition has resulted in higher costs and somewhat higher prices, although neither is as yet excessive.

Governmental Restrictions. The impact of the chain during the twenties upon independent retailers and wholesalers was so great that efforts were made almost immediately to obtain legislation that would hamper the operation of chain systems. Accordingly, during the late twenties and the thirties, a number of state legislatures were induced to pass antichain store tax bills. A total of 28 states have passed such laws at some time, and as of 1958 a total of 14 states still had discriminatory tax legislation in effect.[12] Most such laws impose graduated annual license fees based on the number of stores located in the state. The Louisiana and Mississippi acts, however, base the tax rate on the number of stores operated by the chain throughout the United States. The highest tax rates at present are those of West Virginia, $1,000 per store for each store in excess of 75, and Texas, $825 per store for each one in excess of 50.[13] But the total tax bill for a large national chain would be greater in Louisiana and Mississippi which tax each store in the state at the same rate, one that is dependent upon the number of stores operated nationally.

Although these laws are burdensome to the chains and they undoubtedly have been a factor in the reduction of the number of chain store units noted previously, they do not appear at present to be an important restraint upon chain store development. An exception may exist in the gasoline service station field in which a tax of several hundred dollars per station might be a definite deterrent. But in food, department, and variety stores, which have a large sales volume per store, the level of present taxes would not normally be a significant handicap. Nevertheless, such legislation is discriminatory and it is encouraging to know that several states have repealed their laws in recent years. Moreover, although many laws have been introduced into state legis-

[12] See Minnie B. Tracey, *The Present Status of the Chain Store Tax, With Special Reference to the Louisiana Law* (Ruston: School of Business Administration, Louisiana Polytechnic Institute, April 1958).

[13] Lesser amounts are charged, as low as $5 or $10 per store, for the first few stores, and the rates are then graduated upward for additional stores to the maximum designated.

latures during the fifties, very few have passed and these have been amendments to previously existing acts.

No chain store tax bill has ever been passed by the federal government, although one introduced in the Congress in 1938 would have imposed a virtual "death sentence" upon the operations of national chains. The federal government, however, has passed laws to curtail the low-price advantages of the chains. Of particular importance is the Robinson-Patman Act of 1936, which limits the special price and service concessions that large purchasers sometimes obtain from sellers. In addition, the Miller-Tydings Act of 1938 made it legal for manufacturers engaged in interstate commerce to operate under state resale price maintenance laws ("fair trade acts"). These laws will be discussed in detail in later chapters, but without doubt they have had a restrictive influence upon chain store development—although obviously not a substantive one.

Competition of Independents. Much more effective than these legal restrictions, and from the social point of view much more desirable, have been the efforts of independent retailers and wholesalers to improve their own business methods and to compete with the chain on its own ground of more efficient operation and more effective buying. Retail and wholesale associations, trade journals, universities, governmental agencies, and many manufacturers have made a great deal of information available to assist the independent retailer in the more effective operation of his business. Many individual merchants, likewise, have studied chain store competitors with a view to adopting their methods or devising other suitable plans for meeting their competition. Probably the most effective movement in this direction has been the formation of contract chains for the purpose of securing the advantages of large-scale operation while retaining the advantages of independent ownership and operation.

THE CONTRACT CHAIN

A contract chain is an organization composed of a group of retailers who own and operate their own stores but carry on certain activities in common. The object of the association is to obtain the advantages of the chain in the performance of certain marketing operations. These operations almost universally include buying and frequently include advertising, the promotion and sale of group brands, and other merchandising activities. A degree of uniformity in store operation is frequently realized, and store fronts and layouts, as well as other aspects of physical appearance, may be somewhat similar from one store to another.

There are two distinct types of contract chains that are of importance. The first is the retailer-cooperative chain in which a number of independent retailers organize into a group for the primary purpose of buying cooperatively. They customarily establish, own, and operate their own wholesale warehouse. Patronage dividends are paid to members and merchandise is thus made available to the retailer members at cost or virtually so. Considerable emphasis is placed on economical operation of the wholesale warehouse so that the net cost of merchandise to the retailers will be as low as possible. Thus the wholesale portion of the business is operated in much the same way as is that of the corporate chain. Retailer-cooperative groups operate essentially on a local basis under various names, but many of them in the food field are affiliated with Shurfine, Inc., a successor to the National Retailer-Owned Grocers, which supplies local groups with certain private brands of merchandise.

The second type of contract chain is the wholesaler-sponsored voluntary group. Here the initiative is taken by a local wholesaler who forms an association of independent retailers. The wholesaler in turn is often affiliated with wholesalers in other cities in a national organization which provides buying and merchandising assistance, contracts for the manufacture of private brand merchandise, and even in some instances provides its own manufacturing facilities. The voluntary chain places less emphasis on economy in wholesale operation than does the retailer-cooperative, although in recent years there has been some change in this philosophy, but does more to assist the retailer members with their merchandising and operating problems.

Examples of well-established voluntary chains are the Independent Grocers' Alliance (IGA), Red & White, Spartan, Super Valu, and Clover Farm in the food field, and the Ben Franklin stores sponsored by Butler Brothers in the variety merchandise area. The Rexall Drug Company constitutes an interesting variation. It owns 160 chain units itself, supplies merchandise to 330 independent "agency" stores, and has 11,000 franchised dealers who handle Rexall products along with other brands. Other corporate chains which have independent affiliates include the Western Auto Supply Company and the Walgreen Drug Company, as well as Butler Brothers which owns and operates several department stores and a variety store chain.

Growth and Present Importance

The earliest known contract chains in the United States—of the retailer-cooperative type—were the New York Consolidated Drug Company and the Baltimore Wholesale Grocery Company, which were organized in 1887. One

year later the Frankford Grocery Company, Inc., was formed in Philadelphia. But despite this comparatively early beginning, the movement developed very slowly until 1925. Since that time its growth has been remarkable, particularly among grocery retailers.

Contract Food Chains. In the food field, contract chains grew rapidly between 1925 and 1939. As of 1930, there were some 550 groups with approximately 60,000 retail members of which almost 60 per cent belonged to voluntary groups and the remainder to cooperative associations. During the thirties, the number of groups increased by about one third, but the number of retail members grew to more than 108,000, or by about 80 per cent.[14] The 1939 Census enumerated 638 voluntary group wholesalers doing 30 per cent of the total wholesale sales volume in general-line groceries and 136 retailer-cooperative warehouses with 7 per cent of the total volume. It should be understood, however, that voluntary group wholesalers do not confine their sales to affiliated independent retailers. In all probability, therefore, voluntary group retailers in 1939 were not obtaining more than 15 per cent of the sales of retail grocery stores.[15]

Another period of growth for contract chains, especially for the retailer-cooperatives, has taken place since World War II. According to a special study of the Federal Trade Commission, voluntary group retailers in 1958 obtained 20 per cent of total grocery store sales, and retailer-cooperatives obtained 17 per cent.[16] Both figures represent significant increases in relation to prior years, but the gain of the retailer-cooperatives is much the greater.[17] There has been, however, a decrease in the number of firms participating in contract chain organizations, a decrease which reflects primarily the substantial

[14] These figures were collected by the American Institute of Food Distribution, Inc., and published annually by the *Progressive Grocer* in "Facts in Food and Grocery Distribution."

[15] Retailer-cooperative warehouses also sometimes sell to nonaffiliated retailers, but the volume involved is nominal—about 2 per cent in 1958. Moreover, there has been a trend since World War II for voluntary group wholesalers to do a greater proportion of their total business with member retailers. In 1958 about 60 per cent of the volume of voluntary group wholesalers was sold to member stores and 40 per cent to nonmembers. FTC Food Marketing Inquiry, *op.cit.*, pp. 171, 210–11.

[16] The study states that these estimates are subject to some margin of error and that there are duplications because some of the smaller corporate chains also belong to contract chains. See FTC Food Marketing Inquiry, *op.cit.*, esp. pp. 19–26.

[17] It should be understood that these increases have come at the expense of unaffiliated independents and not at the expense of the corporate chains. Based on the FTC study, it may be estimated that the 1948 shares of the grocery store market were approximately as follows: corporate chains (11 or more stores) 35 per cent, voluntary groups 16 per cent, retailer-cooperatives 10 per cent, and unaffiliated independents 39 per cent. The corresponding figures for 1958 are 43, 20, 17, and 20. Estimates of the *Progressive Grocer* for 1958, which are widely accepted by the trade, are 39 per cent for corporate chains, 45 per cent for all contract chains, and 16 per cent for unaffiliated independents. See *Facts in Grocery Distribution*, April 1960, p. F20.

decline in the total number of food outlets, both wholesale and retail, that has taken place since 1939. Approximately 70,000 retail establishments belonged to contract chains in 1958, almost 36,000 in voluntary groups and more than 34,000 as members of retailer-cooperatives.

Other Contract Chains. Outside the food field contract chains are less important, but they have attained some significance in both drugs and hardware. The Federal Trade Commission estimated that there were 30 contract drug chains in 1929 with 7,550 retail members, comprising 13 per cent of the retail drug stores of the United States and doing a business of $30 million at retail. In the same year, the Commission found 6 groups in the hardware field with 990 stores and sales of some $6 million.[18] In 1939 the Census reported 13 voluntary group wholesalers and 23 retailer-cooperative warehouses in the drug field. Sales of these wholesalers amounted to more than $35 million, of which almost $30 million were obtained by the retailer-cooperatives. In the hardware field, there were 6 voluntary groups reported and 10 retailer-cooperatives. Sales volume amounted to $21.7 million of which $12.7 million was obtained by the voluntary chains.[19] There were also some 40 contract chains in other fields, excluding food lines as well as drugs and hardware, with sales of almost $87 million, the bulk of the volume being obtained by the voluntary chains.

There is no current information indicating the importance of contract chains in the nonfood lines. Considering the number of independents who are presently affiliated with Rexall, Walgreen, Western Auto Supply, Butler Brothers, and other similar firms, as well as those who belong to the more conventional types of contract chains, it may well be that contract chains have attained greater importance in nonfood lines than is generally assumed. However, they certainly have not had the impact on those lines that they have had in the food field. Consequently, the further discussion of contract chains will be concerned primarily with operations in the food field.

Organization and Operation

The two common characteristics of contract chains, as mentioned previously, are the independent ownership of the retail stores belonging to the chain, and the fact that retailers are associated together in an effort to improve their position as retailers. It is usually stated that these organizations have the advantages that result from the incentive of the independent busi-

[18] Federal Trade Commission, *Cooperative Drug and Hardware Chains*, 72nd Cong., 1st Sess., Senate Doc. No. 82, 1932, pp. 3–4, 23–4.

[19] *U.S. Census of Business: 1939*, Vol. II, *Wholesale Trade*, pp. 59–60.

nessman to operate his own business in his own way for his own profit plus the advantages of the corporate chain in large buying power, centralized promotion of sales, and the use of skilled specialists to determine the best methods of operation for the individual stores. This is an ideal which is realized in varying degree. There is a strong tendency for the very independence of the retail store owner to be manifested in his desire to run his business as he sees fit, regardless of the suggestions of the central organization which may have little power to force him to conform to its policies. This is in contrast to the regular corporate chain in which the central organization can compel the degree of uniformity desired of the unit stores. As a consequence, the central organization of a contract chain must devote much effort to "selling" the independent store owners on the importance of cooperating with it.

In recent years, there has been a strong trend toward a high degree of cooperation with the central organization. Independent retailers have come to realize that such cooperation is necessary if they desire to strengthen their competitive position and that they must be willing to adopt the plans and suggestions of the central organization. In retailer-cooperatives, this central organization is controlled by the retail members and each has an opportunity to influence its plans and policies. In the voluntary chain, the individual retailer exercises less influence—although most voluntary group wholesalers have retailer advisory boards—but he realizes the mutuality of interest that exists between himself and the wholesaler. There are still, however, varying degrees of centralized control in effect in contract chains, and there are basic differences in the philosophy of control between retailer-cooperatives and voluntary chains.

The Retailer-Cooperative. Since retailer-cooperatives are formed in the beginning by an association of retail members, there has been a tendency to emphasize the central buying function and economy in the operation of the wholesale warehouse. Members have been reluctant to spend money for merchandising and supervisory services, since this would increase the cost of the wholesale operation and thus the cost of merchandise to the retail members. Wholesale warehouses have been operated in much the same manner as those of the corporate chain in the sense that there is little sales contact between the wholesale operation and the retailer members. Orders are sent in by the latter and filled by the former. In recent years, many retailer-cooperatives have required that these orders be sent in on a certain day of the week and on no other. Thus, by controlling the flow of orders, regular operations are permitted without peaks and troughs and wholesaling costs have been held to a minimum.

The success of retailer-cooperatives in reducing costs is evidenced by the

expense ratios of the wholesale operation, which in 1939 averaged 5.2 per cent of sales compared with 10.6 per cent for voluntary group wholesalers, in 1948 amounted to 4.6 compared with 8.3, and in 1954 was 4.4 compared with 7.4.[20] Thus, although retailer-cooperatives from the very beginning were obtaining merchandise at a relatively low cost, they were not necessarily making efficient operators of their retail members. Accordingly, especially after World War II, they began to provide the group services for which the voluntary chains are noted. Most of them, as will be seen in the following section, now furnish advertising service and many employ specialists and servicemen to assist retailers with their operating problems. Provision of these services has presumably resulted in wholesaling costs somewhat higher than they otherwise would be, but the net result appears to have been beneficial judging by the large sales increases of food cooperatives that have taken place.

The Voluntary Chain. The situation of the voluntary chain has been the reverse of that of the retailer-cooperative. Since most voluntary groups were started originally by old-line grocery wholesalers, who continued to sell to all retailers who would buy from them regardless of group affiliation, there was little emphasis at first on cost reduction and a great deal of emphasis on service. Salesmen continued for a number of years to call on retailer members as well as other accounts. Many specialized managerial services were rendered to members. Beginning in the early forties, voluntary group wholesalers began to eliminate salesmen and replace them with a smaller number of servicemen. Thus, while there was still an emphasis upon making retailers more effective merchants, more attention began to be paid to the problem of wholesaling costs.

Voluntary group wholesalers still render merchandising and supervisory services to a greater degree than do retailer-cooperatives, as shown in Table 12-3, but the data indicate that the latter have made considerable progress. At the same time, retailer-cooperative warehouses—emphasizing their buying function and low operating costs—have been somewhat more willing to diversify lines and to provide their retail members with nonfood items and perishable foods, as well as the dry grocery lines that virtually all contract chain wholesalers handle. The data in the table indicate the differences in purchasing activities of the two types of organizations.

[20] These figures are for grocery firms and are from the *Census of Business* for the respective years. It was estimated that the retailer members of Certified Grocers, a very successful retailer-cooperative in Los Angeles, during the late forties were obtaining merchandise on the average at a delivered cost of approximately 2.5 per cent above absolute net cost to the wholesale warehouse in carload lots. See Ralph Cassady, Jr., and Wylie L. Jones, *The Changing Competitive Structure in the Wholesale Grocery Trade* (Berkeley and Los Angeles: University of California Press, 1949).

TABLE 12-3

Comparison of the Relative Importance of Selected Services Provided to Retail Members by Contract Food Chains, 1958

	Per Cent Providing Service	
Type of Service	*Voluntary Group Wholesalers*	*Retailer-Cooperatives*
Merchandising and Supervisory Services		
Advertising	90.6	85.7
Managerial Advice	57.6	43.7
Store Engineering	56.7	38.2
Floor Display	41.2	22.2
Accounting System	26.7	10.4
Record Keeping Aids	26.4	9.7
Purchasing Services		
Purchasing Nonfood Items	60.6	71.5
Purchasing Frozen Foods	40.3	58.3
Purchasing Meat	23.9	19.4
Purchasing Dairy Items	23.3	44.4
Purchasing Produce	22.1	29.2

Source: Economic Inquiry into Food Marketing, Part I, *Concentration and Integration in Retailing* (Washington, D.C.: Staff Report to the Federal Trade Commission, January 1960), pp. 167 and 220.

Voluntary group wholesalers have also made, since the early forties, a determined effort to reduce wholesaling costs. Salesmen have been replaced in many instances by printed order forms which the retailers fill out and send to the wholesaler. Simplified order handling procedures have been adopted, and more efficient assembly-line operations have been instituted in the warehouse. Retailers have been limited to weekly orders, as in the case of the cooperatives, and cash payment on delivery is often required.[21] The success of the voluntary groups in reducing costs has been indicated in the previous section. Although average expense ratios in 1954 were still above those of retailer-cooperatives, they were substantially below the voluntary group averages for 1939—7.4 per cent compared with 10.6. Moreover, those voluntary group wholesalers who do the bulk of their business with member retailers have considerably lower ratios than those who do not.[22] Thus a considerable

[21] For a description of the operations of one voluntary group wholesaler, see R. D. Tousley, "Reducing Distribution Costs in the Grocery Field: A Case Study," *Journal of Marketing*, April 1948, pp. 455–61.

[22] In 1948, the only year for which data were collected by the Census, voluntary group wholesalers doing 90 per cent or more of their volume with members had average expense ratios of 5.8 per cent compared with 8.3 for all voluntaries. The corresponding figures

improvement in cost ratios has been shown, especially by those wholesalers who are most dependent upon their affiliated stores.

Conclusions

The gains that have been made by the contract chains in the food field have come at the expense of unaffiliated independents rather than at the expense of the corporate chains. As of 1958 unaffiliated independents obtained only 20 per cent of total grocery store sales. Therefore, it seems unlikely that contract chains can expand their share of the market significantly in the future. To do so, they must either make inroads upon the corporate chain or take over most of the remaining nonmember independents. It would appear that the corporate chains are too well established and too competitive for the former to occur. There is little doubt that they still have a price advantage over most of the contract chain retailers, and they are overcoming their principal disadvantages of lack of flexibility and managerial incentive by giving the store managers more authority and responsibility along with a share of the profits. Neither are the unaffiliated independents likely to be taken over because most of the latter represent small operations. And contract chains are not greatly interested at present in adding small operators to their groups. To do so would increase costs since small orders are expensive to fill. As a matter of fact, some contract chains are dropping small independents from their membership lists and encouraging them to buy from cash-and-carry wholesale outlets.

This means that, if contract chains are to increase their market share, existing member retailers must become even more competitive with the corporate chain units. Greater efficiency and lower costs must be achieved. But this will not be easy to accomplish. The contract chain still has a major problem in obtaining membership loyalty and conformity. Much has been accomplished in this respect, especially by the larger and better organized groups, but the member retailer is still an independent businessman with his own ideas on store operation. He may refuse to go along with group promotions, competitive pricing policies which result in low gross margins, the installation of a good accounting system, or suggested improvements in store building and equipment. Lack of cooperation in these matters in a sense is detrimental to the entire group, but attempts to force compliance must be carefully handled. Not many contract chains are so strong that they can drop non-cooperating members without endangering the entire program,

for retailer-cooperatives were 4.2 and 4.6. *U.S. Census of Business: 1948*, Vol. IV, *op.cit.*, p. 8.45 and 8.46.

although some do exactly this. The greater the degree of centralized control, of course, the greater is the similarity to the operation of the corporate chain, and the greater are the possibilities of losing the advantages of independent ownership and operation.

As a matter of fact, in the food field at least, the outstanding development at the retail level is the converging movement with respect to operation and control. The contract chain is attempting to centralize operations much in the manner of the corporate chain, whereas the latter is moving toward the more decentralized system of the former. Voluntary chains are emphasizing cost reduction while retailer-cooperatives are increasing merchandising and supervisory services. Regardless of whether the form of organization is that of the corporate chain, the voluntary group, or the retailer-cooperative, operations are becoming more and more alike. It would probably be inaccurate to say that eventually they will all meet on a common ground, but it is certainly true that their present similarities are more significant than their original differences.

THE CONSUMER COOPERATIVE

Consumer cooperatives are organizations owned and operated by the consumers who patronize them. There are many types of such organizations: cooperative housing associations, credit unions, cooperatives organized to furnish electricity and telephone service, medical care associations, retail stores, and others. We shall be concerned here only with retail stores, although the general principles of consumer cooperation are the same for all types of cooperative organizations.

Characteristics of Cooperatives

Although cooperatives are typically organized as corporations, often under special state laws, their methods of control differ considerably from those of the regular corporation. The chief organizational features that differentiate the typical cooperative association from other business enterprises are as follows:

1. Democratic control, which is effected by limiting each member to one vote regardless of the amount of stock he may own.
2. A limited rate of return on capital stock.
3. The payment of patronage dividends on the basis of business done with the association.

These three features clearly differentiate the cooperative enterprise from the regular corporation. In the usual corporate organization, control is vested in the common stockholders, each of whom has one vote per share of stock held. In the cooperative association, each member has one vote regardless of the number of shares owned unless state law prohibits this type of arrangement. In the latter case, there may be a limitation placed on the number of shares one member may own. In the corporation the owners supply the capital, and profits are divided in direct relation to the number of shares owned by each stockholder. In the cooperative the customers of the organization supply the capital but a limited rate of interest is paid, and the remaining profits over and above expenses and reserves are divided according to the amount of business each owner-customer has done with the association.

These policies insure that the organization will not be operated for the benefit of a few large stockholders, who may be more interested in a return on their investment than in obtaining low prices or the most desirable merchandise for the membership as a whole. They are the fundamental principles of cooperation, since they are the means by which control of the organization is kept in the hands of its members. The patronage dividend, moreover, is a device which serves to tie the members to the organization and encourages them to do business with it.

The above principles are utilized by all cooperatives regardless of whether they are producer or consumer organizations, agricultural marketing cooperatives, or retailer-cooperative wholesale warehouses. Consumer cooperatives, however, are supposed to observe certain additional principles and policies as established by the original Rochdale Society. These are (1) open membership, (2) the sale of merchandise at prevailing prices, (3) the sale of merchandise for cash, and (4) the setting aside of funds to educate members and nonmembers in the meaning of cooperation. Open membership means that any person can join a cooperative by buying a share of stock. According to the original Rochdale principle, no one is to be denied the privilege of membership because of religious or political beliefs. Membership is sometimes restricted, however, to a particular group, such as farmers or members of a labor union. The policy of selling at prevailing prices has been generally adopted, since it helps the cooperative to avoid the accusation of price cutting. In addition, use of such a policy strengthens the store's financial structure and permits the payment of patronage dividends. The policy of selling for cash and offering minimum services is usually, but not always, observed. Some associations in the past have felt it necessary to maintain services for competitive reasons. Finally, educational efforts are essential to keep members loyal to the organization. Building and keeping membership loyalty is one of

the important problems of cooperatives in the highly competitive retailing system of the United States.

History and Present Importance

The modern consumer cooperative movement was begun in England in 1844 when a few workmen formed the Rochdale Society of Equitable Pioneers. Starting with a single store and a capital of £28, this group sold flour, butter, oatmeal, and sugar. The store did a small business and led a precarious life for some years, but it gradually achieved sufficient success to prompt the growth of a number of imitators in communities nearby. By 1851 there were 150 such stores in the north of England and Scotland. In 1852 the Rochdale pioneers entered the field of production and started to manufacture shoes and clothing. Gradually, either alone or in cooperation with other stores, other products were manufactured and the variety of goods handled in the stores increased. Finally in 1855, a wholesale department was started by the Rochdale store and some of its neighbors. In 1863 the English Cooperative Wholesale Society (C.W.S.) was established, its stock being held by 45 local societies. This organization grew rapidly, and it now has factories, farms, plantations, and buying agents all over the world.

In Great Britain at the present time, there are approximately 1,000 cooperative retail societies with more than 12 million members. These societies operate more than 25,000 retail establishments and obtain between 12 and 13 per cent of total retail sales, including more than 20 per cent of all food sales.[23] Cooperatives are also of considerable importance in other European countries, especially in the Scandinavian nations. They obtain from 10 to 12 per cent of total retail trade in these countries, except in Finland where they do approximately one third of total retail volume.

Importance in the United States. Although consumer cooperatives were started in the United States at about the same time as the Rochdale Society began operations, the movement has been much less important in the United States than in Europe. Although it has had at various times the endorsement of some powerful organizations, including the American Federation of Labor, several church associations, important farm organizations, and the two great political parties, the movement has progressed slowly. There have been sporadic efforts to establish consumer cooperative stores ever since the Order of the Patrons of Husbandry, established in 1867, undertook cooperative buy-

[23] The data are for 1955 and 1956 and are taken from *Consumer Cooperatives*, Bull. No. 1211 (Washington, D.C.: U.S. Department of Labor, Bureau of Labor Statistics, 1957), p. 65.

ing. Various other movements which have fostered consumer cooperation and promoted the establishment of stores include The Sovereigns of Industry (1874), the Knights of Labor (1894), the Right Relationship League (1900), and the Consumers' Alliance (1910); but most of these have been short lived. Many cooperative societies were formed during the latter part of the First World War period, but many of these failed to survive the era of declining prices in 1920–21. A few, however, made steady progress, particularly those selling a limited line of products.

The data in Table 12-4 indicate that there has been a considerable increase in the importance of consumer cooperatives since 1929 but that they still do a negligible proportion of total retail sales volume. As a matter of fact, of the $1,700 million of sales by cooperatives in 1954, over

TABLE 12-4

Consumer Cooperatives: Number of Establishments and Sales Volume, United States, Selected Years

		Sales Volume	
Year	*Number of Establishments*	*Amount (in thousands of dollars)*	*Per Cent of Total Retail Sales Volume*
1929	1,709	116,995	0.2
1939	3,698	224,375	0.5
1948	4,398	1,066,841	0.8
1954	6,135	1,704,449	1.0

Source: U.S. Census of Business: 1954, Vol. I, *Retail Trade,* p. 20; *U.S. Census of Business: 1948,* Vol. I, *Retail Trade,* p. 20; *U.S. Census of Business: 1939,* Vol. I, *Retail Trade,* Part 1, p. 10; U.S. Department of Commerce, Bureau of the Census.

$1,300 million, or 77 per cent, were obtained by feed, farm, and garden supply stores—and these in reality are largely sales to farmers by producer purchasing cooperatives which might be regarded more logically as wholesale transactions. This is the only area, however, in which cooperatives do a significant proportion of total retail volume—about one third of all sales of this type of establishment—and indicates the predominantly rural character of the cooperative movement in the United States. The retailing of food, which constitutes a most important phase of consumer cooperation in Europe, is of little significance in this country. About one fourth of one per cent of grocery store sales are made by cooperatives in the United States, and the ratio has been declining rather than increasing.

Evaluation of Cooperatives

The cooperative store is operated in the interest of the consumer and is controlled by him. Its main activity is the purchase of goods for the benefit of the consumer, whereas in the ordinary retail establishment goods are purchased when the proprietor feels that he can make a profit from their resale. The profit element is lacking in the cooperative store in the sense that most of the profits are paid to members in patronage dividends. Assuming that the cooperative can buy as advantageously and operate as economically as can its competitors, which include the corporate and the contract chain, there would be a net monetary advantage to the consumer-member. The question is whether such an advantage does exist.

The assumption underlying the operation of cooperatives is that they are composed of loyal members who desire to obtain all possible savings. Thus the cooperative store should be able to operate very economically, perhaps even more economically than its competitors, assuming the management of all is equally good. The cooperative presumably need not seek out the most convenient and most expensive locations because members are willing to go out of their way to patronize their store. Expensive and attractive fixtures and equipment are unnecessary for the same reason. Although provision is made for educational expenditures, advertising and other methods of demand creation need not be used to obtain business, since the savings obtained through these economies revert to the members in the form of patronage dividends.

In the United States, however, it has been difficult for consumer cooperatives to follow these policies and still maintain membership loyalty. Convenience of store location is important to the average consumer and he likes to shop in an attractive and well-appointed store. Furthermore, he is easily diverted to the chain store and the contract chain through their advertising of special prices and merchandise. Thus cooperatives have not been able to operate at more economical levels than their competitors, and still retain patronage, and in reality they have had little to offer the consumer that was not already available from the corporate chain.

There are no doubt many factors contributing to the failure of the cooperative to achieve the significant role in the United States that it has achieved in Europe. But the most important factor would seem to be the development of a dynamic and competitive retailing system in America, and in particular the early development of the corporate chain. Multiple-unit retailing, except for cooperatives, has been of little importance in Europe,

although chain store systems are now beginning to make progress. But in the United States, the rise of the corporate chain made it difficult for cooperatives to obtain a firm foothold. The chains could certainly buy at least as economically as the cooperatives, and their low ratios of expenses and net profits left little advantage to the latter. Assuming that the cooperatives could have met the prices of the chains and still made an equivalent profit, the small saving that would have been paid to the members, probably not more than 2 per cent of purchases, would have had little appeal to the average American consumer with his relatively high level of living.

Consumer cooperatives have also suffered from inferior management and the problems involved in democratic control. The members of a cooperative are not likely to have a wide knowledge of business methods, and they are often reluctant to pay the salaries necessary to employ a high caliber of managerial personnel. Moreover, there exists in the cooperative the same problem of managerial incentive that has already been mentioned in connection with the chain and other large-scale retail agencies. Finally, American consumers have not had the community of interest and the sense of social solidarity that have marked the European cooperative movement. Thus they have not developed that spirit of group loyalty which is essential to the success of any group enterprise.

Essentially then, the cooperative has faced in the United States a different economic and social climate from that found in Europe, and it has been unable to make very much progress. There is little reason to believe that the consumer cooperative in the future will attain a really significant place in the American retailing system. Certainly if it does, great changes will have to be brought about in the basic economic and social structure of the nation, changes that are not evident at the present time.

CASE PROBLEM—THE ACME FOOD MART

The Acme Food Mart is the third largest food retailer in Centerville, a well-to-do community of about 15,000 population. It operates as an unaffiliated independent retailer in the downtown business district where parking space at times is somewhat difficult to obtain. As a result, it still provides, unlike most of its competitors, credit and delivery service. At the present time, the Acme Food Mart is considering whether to accept an invitation to join the United Merchants, a retailer-cooperative organization which operates throughout the area from wholesale headquarters located in Centralia, a city of 300,000 population some 50 miles distant.

The two largest food stores in Centerville are located outside the downtown business district and have ample parking facilities for customers. One of these stores is a unit of one of the largest national chains, whereas the other is an IGA

affiliated independent. Both stores are believed to have an annual sales volume of from $750,000 to $1,000,000 each. Both operate on a regular supermarket basis, with self-service in all departments, a considerable volume in nonfood items, and no credit or delivery service. The Acme Food Mart in contrast does not handle nonfood items, and it has self-service only in the dry groceries department. Its annual sales volume amounts to about $300,000. It does have one locational advantage perhaps in relation to the two regular supermarkets in that all of the drug, hardware, apparel, and general merchandise stores of the community are also located in the downtown business district. This advantage is shared with two or three smaller food stores which operate in much the same way as does the Acme Food Mart except that the latter has placed greater stress on credit and delivery service.

The United Merchants is a well-established retailer-cooperative, but for some reason has never had a retail outlet in Centerville. It handles dry groceries and frozen foods and has recently added a few nonfood items. Its expense ratio runs about 4 per cent of sales, and Acme Food Mart can thus expect to purchase at least the food lines at a markup of 4 per cent above carload wholesale cost in Centralia plus delivery charges to Centerville. If it decides to join United Merchants, Acme Food Mart will have to invest $500 in stock of the cooperative. It will be entitled to patronage dividends and can participate in a cooperative advertising program if it so desires. No particular requirement is made by United Merchants as to the amount of purchases that Acme must make through its facilities, but it is understood that it should amount to a very substantial proportion of requirements.

The Acme Food Mart for some time has purchased the bulk of its dry groceries and frozen foods from the Blackwell Company of Centralia, which is the IGA wholesaler for the area. It obtains the same terms of sale as any IGA retail store but is not permitted to stock IGA private brands. The Blackwell Company has an expense ratio, including profit, of about 6 per cent, but unlike United Merchants charges its customers a markup over cost according to the volume purchased each week. The Acme Food Mart is not large enough to obtain the lowest price, and its average cost of purchases is about 7.5 per cent over Centralia wholesale cost plus delivery charges to Centerville.

Should the Acme Food Mart join the United Merchants? If it does, are there any changes in operations that can be made to take maximum advantage of its membership? Should these changes be made?

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PART IV

THE MARKETING STRUCTURE: WHOLESALE DISTRIBUTION

13. THE BASIC WHOLESALING STRUCTURE

THE NATURE OF WHOLESALING

The word "wholesaling" means literally to market goods in relatively large quantities. It is true that most wholesale transactions do involve larger units of sale than do most retail transactions, but there are many exceptions. Therefore, "wholesaling" is actually used to designate all sales to business buyers, including governmental and institutional buyers, whereas "retailing" includes those sales made to the ultimate consumer for the purpose of individual consumption.

Wholesaling is often thought of as the work of wholesale middlemen who sell manufactured products to retailers and other business buyers and who handle raw materials and agricultural products in the wholesale markets. But the work of wholesaling is not necessarily performed solely by such middlemen. Manufacturers often sell directly to retailers or to other manufacturers and perform the wholesaling functions, and large retailers who buy directly also are usually involved in wholesaling. In addition, a large volume of wholesale business is carried on by farmer-controlled cooperative marketing associations and by large mining and forest products operators.

Wholesaling is found in the marketing of virtually all classes of goods and is concerned with all three of the marketing processes: concentration, equalization, and dispersion. Although all wholesale operations have much in common, the wholesaling of manufactured goods differs somewhat from the wholesaling of natural raw materials and particularly from the wholesaling of agricultural products. As has been previously indicated in the introductory chapters, there is nothing in the marketing of manufactured products to compare with the growers' local market. This is because the large scale of manufacturing operations has practically eliminated any need for the physical con-

centration of manufactured products at this level of operations. And for the same reason, it is not likely to be necessary to concentrate the products of small manufacturers at wholesale markets in order to obtain adequate quantities of identical products. When sales are made, the required quantity tends to be shipped directly from a single factory. There are exceptions, of course. When the buyer tends to be unusually large in relation to suppliers, as are automobile manufacturers relative to the suppliers of parts and accessories, or when manufacturers operate on a relatively small scale, as is the case in some textile and food lines, purchasers must sometimes buy from several sources in order to obtain enough products of a kind to supply their needs. In such cases, concentration is necessary.

Although the concentrating efforts carried on in the central market for agricultural products are not usually duplicated in the manufacturers' market, the assembling and dispersing efforts of the jobbing market for farm products are closely paralleled. This is, of course, particularly true of products for personal consumption. But it is also true in a considerable degree of some industrial goods, such as machine parts, that are sold to other manufacturers as production materials, and of some equipment and supplies sold to manufacturers, public utility companies, contractors, farmers, and other middlemen. The economy of shipping as near to the market as possible in carload lots tends naturally to develop dealers who specialize in purchasing large lots to break into the smaller quantities demanded by the trade. Such dealers center in the larger cities because of the greater number of potential buyers located there and because of the greater facilities that exist for receiving and shipping. If manufacturers prefer to sell directly to retailers or other buyers, their sales branches or central offices will center at such points for these same reasons. And retailers who prefer to buy directly, in addition to receiving representatives of manufacturers at their own places of business, often send their buyers to these markets, where large quantities and varieties of goods are available from numerous supply houses.

WHOLESALE MARKETS [1]

The important wholesale markets tend to be located in the major population centers of the nation. In 1954 some 63 per cent of the sales of merchant

[1] For analyses of specific wholesale market areas, see Edwin H. Lewis, *Wholesaling in the Twin Cities*, Studies in Economics and Business No. 15 (Minneapolis: University of Minnesota, 1952); R. D. Tousley and R. F. Lanzillotti, *The Spokane Wholesale Market*, Bull. No. 18 (Pullman: Bureau of Economic and Business Research, Washington State University, 1951); Edwin H. Lewis, "Wholesale Market Patterns," *Journal of Marketing*, January 1948, pp. 317–26; and E. Guy Rasmussen, "Hardware Wholesale Trading Cen-

wholesalers and almost 69 per cent of the sales of other types of wholesalers were made in the 33 metropolitan areas with 500,000 or more inhabitants.[2] These same 33 metropolitan areas contained in 1950 almost 38 per cent of the total population. Thus it is evident that wholesale markets are located in the more heavily populated areas and, furthermore, that wholesale sales are much more heavily concentrated in these areas than is the population.

These large cities are important centers for wholesale activities because they are situated at the centers of large buying areas and have superior transportation facilities. Moreover, most of these cities are also important centers of manufacturing. They serve, consequently, not only as assembling points for products from distant factories, but also as dispersing points for products manufactured in the metropolitan area.

New York is thought of primarily as a commercial city. Its harbor and its means of reaching an important hinterland by rail and water have been among the chief reasons for its development as an important import and export market for manufactures as well as for raw materials and foods. But New York is also the greatest manufacturing center in the country. This, together with the enormous population in the city and its environs, makes it the largest wholesale market in the country. Chicago is also a great wholesale market for finished products of all kinds, and a leading manufacturing center. St. Louis, with adequate transport facilities to the vast agricultural districts to the west and south, early became the greatest distributing point in the country for hardware products. Kansas City in a similar location became the foremost distributing point for agricultural implements and machinery.

Location of Wholesale Districts

Although wholesale operations tend to be concentrated within the larger cities, wholesale market districts within these cities are not necessarily well defined. There has always been a tendency for the wholesale markets for agricultural products to be more unified and more highly centralized than those for manufactured goods. The existence of organized exchanges, auction markets, and terminal public markets has led to a concentration of the wholesale facilities for agricultural products around these markets. To a certain extent this concentration still exists, but the trend toward direct marketing previously noted has led to decentralization of marketing and marketing fa-

ters and Trading Territories in Nine Southeastern States," *Journal of Marketing*, October 1943, pp. 165–71.

[2] *U.S. Census of Business: 1954*, Vol. III, *Wholesale Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 9.

cilities and has impaired the degree of efficiency with which the equalization process is performed during the wholesale operation. And the large amount of direct marketing that has always existed in manufactured goods has inhibited the development of centralized wholesale facilities for these products.

When a high degree of centralization is found in the location of wholesale establishments, it commonly results from the desire of businessmen to locate in those districts into which goods are easily shipped from outside sources and from which they can be easily delivered within the metropolitan area or shipped to buyers located outside the city. This often means a location near transportation terminals; but other factors, such as traffic congestion, high land values, or the importance of being near consumers, may cause the markets to locate elsewhere in the city or may result in scattering wholesale operations throughout a wide area with little or no concentration at any one point.

As cities increase in size, two fairly definite tendencies begin to appear in the location of wholesale markets. Wholesalers of some goods tend to congregate in a common center. Wholesalers of other goods tend to follow their customers. The first tendency is particularly likely to prevail when buyers wish to see the commodities they plan to purchase in order to compare style, quality, and price, as with furs, millinery, women's clothing, and textiles. The convenience of the buyer is an important influence which tends to keep the wholesale districts for such commodities concentrated within a small area. This same factor may cause the district in which style goods are sold to be located near the large retail stores. These large stores are important buyers, and buyers from out of town go to them as well as to manufacturing and wholesale houses to study fashions and values. This type of market is, of course, most important in New York City, to which buyers of such goods come and in which the largest retail business in the country is carried on. In Chicago it is exemplified in the markets centering in the Furniture Mart and the Merchandise Mart. This feature of centralization is of less importance in other cities, although a number of regional markets are developing in furniture, house furnishings, and apparel lines.[3]

The second tendency is more likely to appear among wholesalers of standardized and nationally advertised convenience goods, such as hardware, drugs, and groceries, which are well known to the consumer and the retail trade. Buyers of such products do not need to come to market to compare quality,

[3] See *Business Week*, July 25, 1959, pp. 88 ff., for an account of the development of the Dallas Homefurnishings Mart and the Dallas Trade Mart. Dallas represents one of several expanding regional furniture markets. Others include Los Angeles, San Francisco, Atlanta, and High Point (North Carolina).

style, and price. Hence the need for concentration in a small area to meet the convenience of buyers is not essential. Moreover, the retail stores that sell such goods reorder at frequent intervals and expect prompt delivery. This makes it necessary to have supplies near at hand in order to make deliveries promptly and economically. There is a tendency, consequently, for individual wholesalers to locate wherever retail trade in the type of goods carried is sufficiently concentrated to supply a volume of business which will make economical operation possible. As a result, there is less concentration of such wholesale houses in single areas. In the smaller city the tendency is less marked, however, because the whole city must be drawn on to secure an adequate volume of business. There is, consequently, a tendency for wholesale operations in small cities to be located in central areas, near incoming transportation facilities and at points from which a wide area can be readily supplied.

Retailers who handle goods on an exclusive or limited basis, such as automobiles, men's clothing, and household refrigerators, are likely not to reorder so frequently as do convenience goods retailers. Neither do they need to compare styles and prices as closely as do those who retail shopping goods. Those who wholesale such products attempt to find economical points at which to carry stocks in locations near to incoming and outgoing transportation facilities. These facilities are also important to other types of wholesalers who sell in large amounts to buyers outside the city in which they are located.

IMPORTANCE OF WHOLESALE MIDDLEMEN

As has been pointed out previously, not all wholesaling is done by wholesale middlemen. Both manufacturers and retailers perform the work of wholesaling. Therefore, we have no measure of the total volume of wholesaling. Data are presented, however, in Tables 13-1, 13-2, and 13-3 which show the importance of wholesale middlemen in the United States as classified by the Bureau of the Census. Because of changes in classification from one census year to another, the data in these tables are not completely comparable. The number of establishments in 1929 and 1939 are somewhat overstated in relation to the later years. Sales volume figures for the same years are also overstated but not to the same degree because the establishments involved are relatively small. In other respects, the data for the earlier years have been revised from the data originally reported and are reasonably comparable with the 1958 figures.

In 1958 there were in the United States, excluding Alaska and Hawaii,

285,996 wholesale establishments with one or more paid employees.[4] These establishments had a total sales volume of almost $285 billion and employed almost 2,800,000 persons. The data for 1958 and preceding years are shown in Table 13-1. It will be noted that there has been a continuous increase in

TABLE 13-1

Wholesale Trade in the United States: Number of Establishments, Sales Volume, and Paid Employees, Selected Years

Year [a]	*Number of Establishments*	*Sales Volume (in thousands of dollars)*	*Paid Employees* [b]
1929	162,936	65,378,051	1,549,910
1939	190,379	53,766,426	1,553,062
1948	216,099	180,576,659	2,305,403
1954	252,318	234,974,422	2,590,236
1958	285,996	284,970,807	2,797,341

[a] Establishments and sales volume figures for 1929 and 1939 include establishments without paid employees which are omitted from later tabulations.

[b] As of the work week nearest November 15. Excludes employees of purely administrative units.

Source: U.S. Census of Business: 1958, Wholesale Trade, BC58-WA1, *United States Summary,* 1961, p. 1–5; *U.S. Census of Business: 1954,* Vol. III, *Wholesale Trade,* 1957, p. 5; U.S. Department of Commerce, Bureau of the Census. The establishments figure for 1929 has been corrected as authorized by the Bureau of the Census, an editorial error having been made in the original publication.

both number of establishments and number of employees from one census year to the next. The number of establishments actually increased by 16 per cent between 1929 and 1939, by 22 per cent[5] between 1939 and 1948, and by 57 per cent between 1948 and 1958. These increases are undoubtedly due in part to better enumeration methods from one census to the next, but there is little doubt that wholesale establishments have tended to grow in number, in depression times as well as in more prosperous eras.

The general growth of wholesaling is more accurately reflected, however, by the growth in the number of paid employees.[6] It will be noted that this

[4] The Census does not include, in its tabulations of wholesale trade, establishments without paid employees. Such establishments are numerous—there were about 80,000 in 1954—but their volume of business is not large.

[5] This figure is based on the tabulation originally reported in the 1948 *Census of Business* of 243,366 establishments in 1948 and 199,726 in 1939. These figures are more comparable than those in Table 13-1.

[6] This is true for the obvious reason that the increase in number of establishments

figure for 1939 is only nominally higher than the comparable one for 1929. Between 1939 and 1948, however, the increase in number of employees was 48 per cent, and between 1948 and 1958 it was 21 per cent. These rates of increase, if allowances are made for gains in productivity, correlate closely with the rates of growth experienced by the economy during these periods.

Importance by Classes of Wholesalers

Comparing total figures for all wholesale establishments does not give a complete picture, however, and it is desirable to look at the data for the various major classes of wholesalers.[7] As will be noted in Tables 13-2 and 13-3, there are five such major classes established by the Census.

"Merchant wholesalers" are regular wholesale middlemen of various types, excluding petroleum bulk plants and assemblers of farm products, who take title to the merchandise they sell. "Manufacturers' sales branches and sales offices" are not really middlemen in the ordinary sense of the word but sales units of manufacturing firms. To the extent that they sell to industrial users and retailers rather than to merchant wholesalers, they represent a form of direct marketing. "Petroleum bulk plants and terminals" are the wholesale outlets of the petroleum industry and may be operated either by independent merchant wholesalers or as sales branches of the refining companies. "Merchandise agents and brokers" are agent middlemen and include those who handle agricultural products as well as those who assist in the transfer of title to manufactured goods. The final category, "assemblers of farm products," include the merchant middlemen and some of the agent middlemen engaged in the concentration of agricultural products in growers' local markets.

Wholesale Establishments. It will be noted in Table 13-2 that in 1958 almost two thirds of all wholesale establishments were merchant wholesalers. It will also be noted that a substantial increase took place in the number of merchant wholesalers, both absolutely and relative to other operating types, between 1929 and 1958. Although increases in number of establishments were reported for all operating types, except for assemblers of farm products,

is not a measure of growth and also because of the fact that errors and inconsistencies in the counting of establishments do not influence the "employees" figure to the extent that they do the "establishments" figure. Most establishments that are "missed" are small and would have few paid employees.

[7] The Bureau of the Census appears to feel that the total figures may also be misleading. In 1954, for example, a total sales volume figure for all wholesale establishments was not published. The reason given was that such a figure is difficult to interpret because of the great differences in types of operation and the fact that wholesalers make some sales to other wholesalers.

TABLE 13-2

Comparison of Number of Wholesale Establishments in the United States by Type of Operation, Selected Years

	Establishments									
	1929 [a]		*1939* [a]		*1948*		*1954*		*1958*	
Type of Operation	*Number*	*Per Cent of Total*	*Number*	*Per Cent of Total*	*Number*	*Per Cent of Total*	*Number*	*Per Cent of Total*	*Number*	*Per Cent of Total*
Merchant Wholesalers	77,079	47.3	98,037	51.5	129,117	59.7	165,153	65.5	189,728	66.4
Manufacturers' Sales Branches and Sales Offices	16,863	10.4	17,926	9.4	23,706	11.0	22,590	8.9	25,181	8.8
Petroleum Bulk Plants and Terminals	19,611	12.0	30,825	16.2	28,351	13.1	29,189	11.6	30,424	10.6
Merchandise Agents and Brokers	18,467	11.3	21,083	11.1	18,138	8.4	22,131	8.8	26,567	9.3
Assemblers of Farm Products	30,916	19.0	22.058	11.8	16,787	7.8	13,255	5.2	14,096	4.9

[a] Includes establishments without paid employees which are omitted from later tabulations.

Source: *U.S. Census of Business: 1958, Wholesale Trade, op.cit.*, pp. 1–5; *U.S. Census of Business: 1954*, Vol. III, *Wholesale Trade, op.cit.*, p. 6. Percentages computed by the writers.

the increase reported for merchant wholesalers—almost 150 per cent—was much greater than that which took place for the other operating types. This does not necessarily mean, however, that merchant wholesalers are the dominant type of operation in all respects. In order to get a complete picture, it is necessary to look at the data on sales volumes in Table 13-3.

Sales Volumes. Merchant wholesalers obtained 43 per cent of the sales volume of all wholesale establishments in 1958, almost exactly the same proportion as obtained in 1929. Manufacturers' sales branches and offices accounted for more than 30 per cent of the total in 1958, compared with less than 25 per cent in 1929. Petroleum bulk plants also increased their proportion of total sales between these two dates, whereas agents and brokers and farm products assemblers lost ground relatively. The data for these and other years are shown in Table 13-3.

Somewhat more meaningful figures perhaps, if one desires to study trends, are to be found in the percentage changes in sales volume by type of operation. The largest sales gain, comparing 1958 with 1948, was obtained by petroleum bulk plants—an increase of 92 per cent. Manufacturers' sales branches and offices increased in dollar volume by 73 percent and merchant wholesalers by 59 per cent. The increase for agents and brokers was only 35 per cent, whereas assemblers of farm products actually showed a decrease in sales of 9 per cent during the decade. Comparisons between 1929 and 1958 show similar relationships, except that a comparatively small increase took place in the sales of farm products assemblers. Interestingly enough, the figures for merchant wholesalers, a 59 per cent increase for 1958 in relation to 1948 and an increase of 331 per cent in relation to 1929, are very similar to the increase in *retail* sales volume during the same periods—55 per cent and 318 per cent respectively. Thus merchant wholesalers appear to have maintained their position in relation to general changes in volume despite the fact that manufacturers' sales branches have taken over an ever greater proportion of the wholesaling task during this time.

In this connection, it is interesting to note the sales of merchant wholesalers by class of customer as shown in Table 13-4 for various years from 1935 to 1954. If the data are at all comparable, there was a relative decrease in 1948 and 1954 in sales to retailers and an increase in sales to industrial users and to other wholesalers. Perhaps these figures merely indicate that industrial goods have constituted a larger proportion of the total output of manufactured goods since World War II than they did prior to that time. On the other hand, it may be true that merchant wholesalers have gained ground relatively in the wholesaling of industrial goods while losing ground in the sale of

TABLE 13-3

Comparison of Sales Volume of Wholesale Establishments in the United States by Type of Operation, Selected Years (in millions of dollars)

Type of Operation	Sales Volume									
	1929 [a]		1939 [a]		1948		1954		1958	
	Amount	Per Cent of Total	Amount	Per Cent of Total	Amount	Per Cent of Total	Amount	Per Cent of Total	Amount	Per Cent of Total
Merchant Wholesalers	28,212	43.2	21,811	40.6	76,533	42.4	101,101	43.0	121,707	42.9
Manufacturers' Sales Branches and Sales Offices	16,175	24.7	14,254	26.5	50,800	28.1	69,534	29.6	87,700	30.9
Petroleum Bulk Plants and Terminals	2,390	3.7	3,808	7.1	10,483	5.8	16,038	6.8	20,131	7.1
Merchandise Agents and Brokers	14,517	22.2	11,779	21.9	32,840	18.2	39,251	16.7	45,225	15.9
Assemblers of Farm Products	4,054	6.2	2,114	3.9	9,920	5.5	9,051	3.9	8,999	3.2

[a] Includes sales of establishments without paid employees which are omitted from later tabulations.

Source: U.S. *Census of Business:* 1958, *Wholesale Trade, op.cit.*, pp. 1–5; U.S. *Census of Business:* 1954, Vol. III, *Wholesale Trade, op.cit.*, p. 6. Percentages computed by the writers.

TABLE 13-4

Distribution of the Sales of Merchant Wholesalers by Class of Customer, Selected Years (per cent of total sales)

Class of Customer	*1935*	*1939*	*1948*	*1954*
To Retailers	59.2	58.9	46.9	45.2
To Industrial, Commercial, and Similar Users	24.9	23.6	31.8	32.0
To Wholesale Organizations	10.2	11.6	13.7	15.1
To Consumers and Farmers	1.9	1.9	1.6	2.8
For Export	3.8	4.0	6.0	4.9

Source: U.S. Census of Business: 1954, Vol. III, *Wholesale Trade, op.cit.*, p. 18.

consumer goods to retailers. The information is not sufficiently complete to make a definite interpretation.[8]

CHARACTERISTICS OF WHOLESALE ESTABLISHMENTS

Size Characteristics

As in retailing, there is a tendency in wholesale operations for a small number of units to obtain a large proportion of the total volume of sales. The degree of concentration in fact appears to be very similar to that found for retailing in the discussion in Chapter 9, although complete sales-size data in wholesaling are available only for merchant wholesalers.

The average sales volume of merchant wholesalers operating for the entire year of 1954 amounted to almost $624,000 per establishment. Those establishments with an annual volume of $2,000,000 or more amounted to only 5.7 per cent of total establishments, but they obtained 50 per cent of the total sales of all merchant wholesalers. At the other extreme, establishments with less than $200,000 in annual sales constituted 51 per cent of all merchant wholesalers but did only 7.1 per cent of total sales volume. The complete data by sales-size groups are shown in Table 13-5.

[8] Ralph S. Alexander does maintain that the wholesaler is losing ground as a source of supply for retailers. His calculations indicate that in 1929 and 1939 sales of merchant wholesalers to retailers amounted to about 40 per cent of total *retail* sales, whereas in 1948 and 1954 they constituted 33 and 32 per cent respectively. See "The Changing Structure of Intermediate Markets and Manufacturers' Marketing Strategy," in Robert V. Mitchell (ed.), *Changing Structure and Strategy in Marketing* (Urbana: Bureau of Economic and Business Research, University of Illinois, 1958), p. 71.

TABLE 13-5

Establishments, Sales, and Operating Expenses of Merchant Wholesalers[a] in the United States by Sales-Size Groups, 1954

Sales-Size Group	Establishments		Sales		Operating Expenses (per cent of sales)
	Number	Per Cent of Total	Amount (in thousands of dollars)	Per Cent of Total	
$10,000,000 and over	815	0.5	18,584,598	18.7	5.7
5,000,000–9,999,000	1,638	1.0	11,223,011	11.3	9.3
2,000,000–4,999,000	6,609	4.1	19,940,896	20.0	11.5
1,000,000–1,999,000	11,969	7.5	16,741,594	16.8	13.8
500,000– 999,000	19,663	12.3	13,952,367	14.0	16.6
300,000– 499,000	19,583	12.3	7,656,795	7.7	18.9
200,000– 299,000	17,886	11.2	4,424,833	4.4	20.5
100,000– 199,000	31,174	19.5	4,532,948	4.5	22.5
50,000– 99,000	25,011	15.7	1,857,660	1.9	25.4
Less than 50,000	25,339	15.9	705,001	0.7	31.0
Total	**159,687**	**100.0**	**99,619,703**	**100.0**	**13.1**

[a] Establishments operated during entire year.

Source: U.S. Census of Business: 1954, Vol. III, *Wholesale Trade, op.cit.,* p. 12. Percentages computed by the writers.

It will also be noted from the table that there appears to be a very close correlation between size and operating expense ratios. The larger the wholesale establishment the lower is the ratio. This relationship seems to hold true without exception, beginning with the expense ratio of 5.7 per cent of sales for the largest size group and ending with 31 per cent for the smallest.

Multiunit Operations

Although the term "chain" is not customarily used in connection with wholesaling, as it is in retailing, multiunit operations do exist in wholesaling, and with respect to merchant wholesalers at least on a scale somewhat similar to that found in retailing. Actually multiunit operations vary greatly according to the class of wholesaler. Single-unit firms in 1954 obtained 82.1 per cent of the total sales volume of merchandise agents and brokers and 68.3 per cent of the volume of farm products assemblers. At the other extreme, the corresponding figure for manufacturers' sales branches and offices was 5.3 and for petroleum bulk plants 22.3.[9] Obviously, since a single branch usually can

[9] These and most of the other figures in this section are from *U.S. Census of Business: 1954,* Vol. III, *Wholesale Trade, op.cit.,* p. 16.

serve only a limited area, most manufacturers and petroleum refiners who establish branches and bulk stations in order to perform the wholesaling operation find it desirable to establish several such branches or stations. This accounts then for the prevalence of multiunit wholesaling for these two operating classes.

With respect to merchant wholesalers, whose operations parallel most nearly those of the retail store, single-unit firms in 1954 constituted almost 87 per cent of total establishments and obtained 71.6 per cent of total sales. These figures are closely comparable with the corresponding ones for retailing of 90 and 70. Wholesale firms consisting of two and three units obtained 10.7 per cent of sales volume, leaving 17.7 per cent for the wholesale "chains" composed of four or more units. This latter figure is somewhat below the 23.7 per cent of retail sales volume obtained by retail chains, but it does indicate that multiunit wholesaling is an important factor in the marketing system.

TYPES OF WHOLESALE MIDDLEMEN

Thus far, the discussion has been concerned only with the major classes of wholesale middlemen. However, there are many different types of operation involved within these major classes. Table 13-6 shows the number of establishments, sales, and operating expense ratios for the various operating types as classified by the Bureau of the Census for 1958. This classification differs somewhat from that used in previous years, and comparisons with those years are not attempted.

The data in the table indicate the basic wholesaling structure in the United States. It will be noted that some of the wholesalers shown there are concerned with importing and exporting and need not be discussed here. A few others are highly specialized types whose operations are more or less evident from their titles. The remainder, however, require some explanation of their functions and place in the wholesaling system. This explanation will constitute the subject matter of the following chapters. Reference will be made from time to time to the data in this table.

With respect to interpretation of the data in Table 13-6, a note of warning should be given here. These are classifications of middlemen, but many middlemen operate in more than one way. A service wholesaler, so classified because a majority of his sales are made on this basis, may also sell some merchandise on a cash-and-carry basis. According to the census classification, his entire sales volume is included under that of service wholesalers. A firm classified as a buying broker may also represent sellers for a portion of his business, but this portion is not credited to "brokers—representing sellers."

TABLE 13-6

Wholesalers in the United States: Number of Establishments, Sales Volume, and Operating Expenses by Type of Operation, 1958

Type of Operation	*Number of Establishments*	*Sales Volume (in thousands of dollars)*	*Operating Expenses* [a] *(per cent of sales)*
Merchant Wholesalers	189,728	121,661,229	13.4
Wholesale Merchants, Distributors	171,236	102,934,483	14.4
Terminal Grain Elevators	690	2,011,291	5.4
Importers	3,444	5,747,629	7.9
Exporters	2,618	5,439,953	6.2
Rack Merchandisers	1,508	637,152	18.3
Cash-Carry Wholesalers	1,860	580,667	10.9
Wagon, Truck Distributors	7,351	1,536,722	14.7
Other Limited-Function Wholesalers	1,021	2,773,332	6.0
Manufacturers' Sales Branches and Offices	25,181	87,757,483	7.7
Branches (with stocks)	15,088	41,797,685	10.8
Offices (without stocks)	10,093	45,959,798	4.1
Petroleum Bulk Plants and Terminals	30,424	20,130,812	11.9
Merchandise Agents and Brokers	26,567	46,422,643	3.3
Auction Companies	1,840	4,552,442	2.5
Brokers			
Representing Buyers	772	1,874,685	1.9
Representing Sellers	3,587	8,119,560	2.4
Commission Merchants	6,972	11,795,915	2.2
Export Agents	693	1,444,658	3.5
Import Agents	349	836,749	3.4
Manufacturers' Agents	9,983	9,687,647	5.9
Selling Agents	2,069	6,876,877	3.5
Purchasing Agents and Resident Buyers	302	1,234,110	2.7
Assemblers of Farm Products	14,096	8,998,640	9.0

[a] Entries for merchandise agents and brokers represent commissions received.
Source: U.S. Census of Business: 1958, Wholesale Trade, op.cit., pp. 1–11.

It should be clearly understood, therefore, that the sales figures in Table 13-6 represent the total sales of middlemen according to their major type of operation.

QUESTIONS FOR DISCUSSION

1. The Bureau of the Census classifies farm implement dealers and farm supply stores as retailers and includes the pertinent data regarding their operations

in the Retail Trade sections of the census reports rather than in the Wholesale Trade sections. In view of the distinctions made in the opening paragraph of this chapter, is this classification correct? What arguments can be made for classifying these stores as retailers? As wholesalers?

2. The statement is frequently found in marketing literature that the wholesaler —meaning essentially the merchant wholesaler—is becoming less and less important in the marketing system. On the other hand, some marketing students—since the publication of the 1954 census figures—have maintained that the wholesaler is making a comeback. What conclusions would you draw from the data contained in this chapter regarding changes in the importance of the wholesaler since 1929?

SELECTED BIBLIOGRAPHY

See references at the end of Chapter 14.

14. THE REGULAR WHOLESALER

The most numerous of the wholesalers classified by the Census, as shown in Table 13-6, are those designated as wholesale merchants and distributors. In 1958 they numbered 171,236 and had a sales volume of almost $103 billion. They engaged in the distribution of a wide variety of commodities, including all types of manufactured goods as well as many varieties of raw materials and agricultural products. But the great majority were concerned with the wholesaling of manufactured products, and the nature of their operations depended primarily on whether they were serving the consumer market or the industrial market.

These middlemen are known by various names, including wholesaler, distributor, and jobber. But regardless of the exact designation used in a particular trade, all perform a similar service. Their function is to purchase merchandise from manufacturers and other suppliers and resell it to retailers, industrial users, and other business buyers. In the process of performing this function, they render such services as are necessary to the sellers and buyers with whom they deal. Thus they are often referred to as "service wholesalers" to distinguish them from certain nonservice or limited-function middlemen, but since the amount of service offered varies greatly it seems preferable to use the term "regular wholesaler." In the present discussion, we shall use this term, or merely the simple designation of "wholesaler," to refer to the regular service wholesaler. No confusion should result since the specialized types of wholesalers that will be discussed in a later chapter have specialized designations.

THE WHOLESALER OF CONSUMER GOODS

There are two reasons for the presence in any marketing channel of the wholesaler of groceries, drugs, hardware, electrical appliances, and other con-

sumer goods. The first is that he renders valuable services to retailers; the second is that he takes over for the manufacturer the wholesaling functions involved in marketing to retailers.[1] Although wholesalers of consumer goods do sell to classes of buyers other than retailers, such as hospitals, hotels, restaurants, educational institutions, and governmental agencies, their chief service is to supply the retailer with the products of many manufacturers.

The Wholesaler's Service to the Retailer

The wholesaler assembles from a wide variety of sources the products which the retailer needs to supply his own consumer trade. He attempts to have these products available at all times, and in order to do this economically and promptly he buys large quantities of goods and has them available in his warehouse. Here he divides them into small lots of the varieties and quantities desired by his individual customers, prepares them for shipment, and delivers them to the transportation agency. If the customer is located within a suitable trucking radius he may deliver them to the retail store. He commonly sells on credit and frequently advises his retail customers on suitable stocks to carry and on merchandising methods.

Buying. Buying is perhaps the most important service the wholesaler performs for the retailer. The greatest service performed by retail merchants for consumers is to assemble at convenient places the assortment of products which the consumer is in the habit of demanding on short notice, and in the marketing of many products much of this work of assembling is performed for the retailer by wholesalers. It is often a difficult task to collect the various commodities that consumers demand. There are hundreds of manufacturers producing articles for grocery, hardware, drug, and dry goods stores. To receive the salesmen of such firms, to answer their letters, or to pay close attention to their selling activities is impossible for any but the largest retail stores.[2] The cost of direct buying proves to be too great a burden for most

[1] Since most regular wholesalers are involved in the marketing of manufactured goods, it will simplify the discussion in this chapter a great deal to refer only to the wholesaling of manufactured products. It should be understood, however, that wholesalers serve producers of natural raw materials and of agricultural goods as well as manufacturers.

[2] "Imagine 50 retailers each ordering an item from 10 manufacturers. 500 orders go out from retailers, 500 shipments come back from manufacturers; 1000 transactions are required to requisition and supply the needed merchandise. Imagine the same 50 retailers ordering the same 10 items from a wholesaler; 50 orders go out from retailers, 50 shipments come back from the wholesaler; 10 orders go out from the wholesaler, 10 shipments come back from manufacturers; a total of 120 transactions are thus required to requisition and supply the same needed merchandise, or a saving of 880 out of a total of 1000 transactions. Multiply this by many thousands and the impossibility of supplying independent retailers without the service of wholesalers becomes apparent. It is mathematically impossible for the average independent retail store to maintain contact

small stores. But the wholesaler makes it his business to keep in touch with sources of supply, and, buying goods to be sold through many stores, he is enabled to purchase in large quantities and so to reduce the unit cost of assembly. This service is particularly important when many different products are handled in a single store.

The retailer who handles but few lines and the products of few manufacturers—as do the shoe store, the men's clothing store, and the automobile agency—can deal directly with manufacturers, and particularly with those manufacturers whose products make up the major items he sells. Consequently wholesalers are not used extensively. This is the case because purchases are few and the quantities involved are large. But even in such lines there are many small stores and some larger stores, carrying small lines of these products, which are best served by wholesalers. Even those stores that can buy directly may make some or all of their purchases from wholesalers because of the other services they perform.

Dividing and Regrouping. The division of large amounts into smaller units and the regrouping of items into the lots desired by retailers constitute important services of the wholesaler. Manufacturers find it advantageous to sell in large quantities. Large orders are more economically handled than are small ones, and freight rates favor quantity shipments. Thus the nearer the product can be moved to the ultimate consumer in large lots the more economically it can be distributed. But most retailers desire to purchase in smaller quantities and only certain specific items. This opens the way to the wholesaler to provide an indispensable service, for the function of dividing and regrouping stocks is commonly performed most economically by an intermediary agency between manufacturer and retailer. Moreover, just as the task of buying is most economically performed by a specialist—the wholesaler—working on a large scale, so he is often the logical medium to divide and regroup goods into the qualities and quantities that retail dealers desire.

Credit Extension. Another important function which the wholesaler performs for the retailer is the granting of credit. Manufacturers are often unable or unwilling to grant credit to retailers. But many retailers would be unable to begin or continue their business if they were compelled to pay cash for all the merchandise they buy. This makes an entering wedge for the wholesaler. If he has sufficient funds, or can obtain credit from manufacturers

with the original producers of the many thousands of items it carries. It is equally impossible for producers to maintain direct contact with all the many thousands of retail outlets through which manufactured goods reach ultimate consumers." From "Distribution through Wholesalers," an address delivered by Flint Garrison, Director-General, Wholesale Dry Goods Institute, at the Convention of the American Cotton Manufacturers Association, Augusta, Ga., April 26, 1935, pp. 10–1.

or from banks, he is able to extend credit to the retailer until the latter has sold a sufficient quantity of merchandise to make payment. Some retailers are kept in business in this way; and it might well be said of many such arrangements that the retail stores serve as outlets for the wholesaler's products and, through this granting of credit, become essentially agencies of the wholesaler.

Merchandising Assistance. As a specialist in distribution, the wholesaler can give other valuable assistance to the retailer. By watching the market with care he can advise what goods are likely to sell best, and in what quantities; he can also advise when to drop and add product lines. In addition, the wholesaler's representatives often assist the retailer in planning his advertising and promotional program, furnish him with selling and merchandising ideas, supply promotional materials, and give advice with respect to store modernization. In some cases wholesalers even provide training for store owners and sales personnel. All in all, wholesalers are in a position to give the retailer many valuable suggestions which an intelligent merchant can use advantageously.

Assumption of Risk. Finally, the wholesaler assumes many risks for the retailer. If the retailer did not buy from the wholesaler, the alternative would be to order directly from manufacturers. And since orders to manufacturers must often be placed far in advance of delivery and for relatively large quantities, this would frequently force the retailer to order more goods than he could sell in a reasonable length of time. This would make it necessary for him to bear the market risks—the risk of falling prices, fashion risks, and the risks of physical deterioration—involved in holding goods for long periods of time. He would be in need of much larger storage facilities and financial resources than he usually possesses. In many cases, the additional expenses involved would more than offset the cost of the wholesaler's services. For when he purchases from the wholesaler, the retailer can buy small quantities at frequent intervals, and the wholesaler bears the brunt of the risk and cares for the financing and storing of the goods. By thus allowing retailers to order in small amounts, the wholesaler assists them to increase the rapidity of their stock turnovers, and thereby makes possible the more economical operation of the large number of small retail stores which modern consumers demand.

By the same token, however, the wholesaler's turnover is thereby lowered. But it seems evident that the total reserve stock necessary to supply the trade of several hundred small retailers is less if held in one central warehouse near the retailers than if each retailer tries to carry sufficient stock to meet the variations in his trade. This is true because the variations in day-to-day demand are relatively less for the total trade of a large number of stores, with reserve stocks in the wholesaler's warehouse, than if each store carried its own re-

serves. In addition, the wholesaler's business is large enough to cause the manufacturer to give him good service, and so he receives prompt deliveries on short notice. Such deliveries are frequently made from manufacturers' stocks carried in the wholesaler's own territory.

It is true that some manufacturers are able to perform the wholesaler's services, and to the extent that this is true, the retailer's difficulties with direct purchasing which have just been outlined do not apply. But many manufacturers find it too expensive to handle the small orders of the average retail store, and are not able to make quick deliveries of such orders. Neither are they willing to grant credit to so many retail customers; indeed they frequently do not have the financial resources to do so. The wholesaler performs, then, many important services for the retailer, services which often are not available from other sources.

The Wholesaler's Service to the Manufacturer

As the wholesaler aids the retailer in assembling products, he also serves the manufacturer in marketing products to retail dealers.

Selling. The wholesaler buys most of his merchandise outright and takes upon himself the problem of selling it to the retail trade, as well as some of the market risks and storage costs the manufacturer would otherwise bear. Instead of attempting direct sales to the retail trade, manufacturers who sell to the wholesaler turn over to him much or all of the task of selling to the retailer. In performing this service, the wholesaler has certain definite advantages to offer: he is a specialist in selling his type of retail trade, he knows the manufacturer's prospective market, and he has a developed sales organization already selling to an existing clientele. These advantages prove of inestimable value to many manufacturers by supplying a selling service which they could not duplicate for anything like the margin between the price received from the wholesaler and the price the wholesaler receives from the retail dealer.

Handling many products as he usually does, the wholesaler can work a given market more intensively than can most manufacturers. In a distant or sparsely populated territory or in selling to small retailers, the wholesaler can make a worthwhile profit, whereas the manufacturer of a single product or a small line of products would find the selling costs prohibitive.

The wholesaler's principal service to the manufacturer then is the provision of an economical selling service. The products of most manufacturers are handled by thousands of retail dealers. If these manufacturers attempt to sell directly to retailers, they must obtain many small orders for individual

products from many retailers in order to have an adequate volume of business. Sales to individual retailers thus would be small and costly. The wholesaler, on the other hand, has many items for sale and when his salesman calls on a retailer he normally takes an order for the products of several manufacturers. Because his costs of taking orders, delivering them, and making collections are thus spread over a number of items, the cost of marketing each one is usually considerably less than it would have been had each of the manufacturers attempted to market his own products to the same retailers.

Transportation and Storage. Again, as has been noted, the wholesaler performs valuable services in regard to transportation and storage. A few large shipments to wholesalers take the place of hundreds of smaller shipments to retail stores, the large shipments being made at a lower unit cost. The wholesaler stores the products at convenient points until they are wanted by the retail trade. Because he handles many products which are constantly being moved in and out of storage, a given warehouse space will perform more service for him than it would for either the manufacturer or the retailer; and he can afford a better storage organization because administrative expenses will be less. By delivering numerous items, rather than a few items as would the average manufacturer, he greatly reduces the unit cost of delivery.

Financial Assistance. Just as the wholesaler gives valuable financial assistance to the retailer by extending credit, so in some instances he assists the manufacturer. This assistance ranges from direct loans, such as are sometimes made to the canners of fruits and vegetables, to the indirect service performed in carrying the accounts of retail merchants. The wholesaler in some fields may contract to take the manufacturer's product before the latter begins to produce; and sometimes he advances funds or pays cash for the product. It should be pointed out, however, that it is customary in most lines for the manufacturer to extend credit to the wholesaler rather than the reverse.

The existence of the wholesaler does simplify, however, the manufacturer's retail credit problem. Manufacturers who sell directly to retailers may have to carry on their books the names of hundreds and often thousands of retailers, and to keep in constant contact with all available sources of credit information. The wholesaler, however, because of his proximity to his retail customers, finds it much less difficult and probably less expensive to secure the desired information. Moreover, since he sells a wider variety of goods than does the average manufacturer, the wholesaler's volume of business with individual customers is large enough to enable him to supervise the extension of credit more economically than can the manufacturer. When the wholesaler relieves the manufacturer of this work, the latter's credit problem is reduced to the need to obtain credit information concerning a relatively

small number of wholesale houses that are usually large enough to have their ratings easily ascertained, and with whom the manufacturer does enough business to warrant the necessary expense for investigation and collection.

Classes of Wholesalers

Wholesalers may be divided into a number of classes based on certain characteristic operations. Most common are the divisions based on the line of goods and number of products carried, the geographical area covered, and the number and nature of the marketing functions performed. These classifications serve useful purposes and are important as evidence of the fact that middlemen develop along different lines in their efforts to obtain business. Not all wholesalers are easily classified, however. Many carry on operations in two or more ways. In fact, many of the wholesale middlemen of consumer goods actually sell a considerable volume of products to buyers in the industrial market. Moreover, some merchant middlemen also sell some items on an agent middleman basis. As previously indicated, the manner in which a particular firm carries on the bulk of its business is the basis normally used in classifying it.

According to Number of Products. Most wholesalers confine their efforts to a single line of products—groceries, drugs, hardware. Some of these carry complete stocks of goods in the line of merchandise which they sell; others carry a more narrow range of merchandise. The former are called "general-line wholesalers" and the latter are called "specialty wholesalers." The distinction is by no means clear-cut, for some general wholesalers carry narrower lines than others, and some specialty wholesalers carry rather wide lines.

General-Line Wholesalers. The general-line wholesaler usually handles thousands of individual items. He finds his greatest advantages in his ability to supply the retailer with almost anything that he wants in a given product line and in the resulting economy of selling large orders. He can sell to small retailers and he can sell to retailers in sparsely settled areas because he handles enough different items to enable him to sell economically, and the wide line handled makes it easy for retailers to buy. This is an advantage to many small retailers. Moreover, many of these general-line wholesalers have developed their organizations so as to gain some of the advantages of the specialty wholesaler. Some have developed lines under their own brand to the sale of which they devote special effort, while standing ready, nevertheless, to supply other products in the complete line; some have departmentalized in order to gain advantages of specialization, and have added specialty salesmen in important lines in order to sell them more effectively.

Specialty Wholesalers. In lines in which retailers handle many products, wholesalers who carry only part of a line have developed. These are called specialty wholesalers. They are common in the dry goods, drug, wearing apparel, and food trades. In the food trade, for example, there are wholesalers who specialize in selling fresh fruits and vegetables; others who carry tea, coffee, and spices, or coffee alone. Wagon distributors, to be discussed later, specialize in selling a narrow line of food products, and candy wholesalers are also found. In the automobile field, there are some wholesalers specializing in replacement parts and others in accessories. Hardware wholesalers commonly sell paint, but paint wholesalers are also found. There are, likewise, wholesalers in the clothing and dry goods fields specializing in the sale of men's and boys' clothing, women's and children's clothing, furs and fur garments, millinery, footwear, hosiery and lingerie, cotton piece goods, notions, or other narrow lines.

Wholesalers who specialize in particular lines in this way become specialists in their narrow fields and have certain advantages over general-line wholesalers. They can know their special markets and products more thoroughly; they often carry a wider selection in their special lines and give better service to retailers. Moreover, because their total line is smaller, less capital is required, more effective stock control is possible, and they can exert more selling effort. This is an important advantage to the manufacturers whose products they sell. They are sometimes handicapped, however, because the very narrowness of the line they market tends toward more expensive marketing, and often makes it uneconomical to sell small stores or stores in sparsely settled areas.

In recent years, there has been a definite trend toward specialty wholesaling. General-line firms still predominate in groceries, drugs, and hardware, but they have lost ground to specialty firms. As of 1954, general-line grocery wholesalers obtained 55 per cent of total grocery and food sales compared with 69 per cent in 1929. Comparable figures for the drug field were 58 and 76 and for hardware 78 and 88. In dry goods, specialty firms obtained 83 per cent of total volume in 1954 compared with 62 per cent in 1929. The trends are similar with respect to jewelry and electrical goods, fields in which the specialty wholesaler is predominant.[3] In selecting wholesalers to represent him, the manufacturer must balance the economy of distributing through general-line firms against the more aggressive sales effort that the specialty

[3] The information in this paragraph is based on census data, and the percentages were calculated by Ralph S. Alexander in "The Changing Structure of Intermediate Markets and Manufacturers' Marketing Strategy," Robert V. Mitchell (ed.), *Changing Structure and Strategy in Marketing* (Urbana: Bureau of Economic and Business Research, University of Illinois, 1958), pp. 73–4.

houses are in a position to give to his products. It is evident that manufacturers are choosing more and more the wholesalers who will "push" the sale of their particular lines.

According to Territory Covered. The size of the territory covered by wholesalers varies greatly. In the staple lines, three important classes of wholesalers are usually distinguished: the national wholesaler, the district wholesaler, and the local wholesaler.

National Wholesalers. Most firms classified as national wholesalers do not actually attempt to distribute their products throughout the nation, but they do cover a wide territory extending over several regions. They tend to be located at strategic centers, such as Chicago, New York, St. Louis, Kansas City, Dallas, and the coast cities. This is particularly true when the firm is operating only one establishment. Most national wholesalers, however, now operate through branches located in various cities. As indicated in the previous chapter, almost 30 per cent of all merchant wholesalers in 1954 were establishments of multiunit firms. Thus, with respect to selling operations especially, many so-called national wholesalers really operate more in the manner of district wholesalers, or even local wholesalers.

It is evident that large general-line wholesalers, whether national or more localized in the area covered, are growing relatively less important. This is due in part to the development of the specialized wholesalers previously mentioned, in part to the development of local and district wholesalers, and in part to the growth of direct sale to retailers by a growing number of manufacturers, many of whom have established branches to perform the wholesale operations involved in the sale of their own products. Although national wholesaling has not entirely disappeared, district and local wholesaling have made substantial gains at its expense.

There has been a consistent tendency to decentralize wholesaling operations, to bring the point of wholesale distribution closer to the ultimate market. There are a number of reasons for this, but the basic factor has been the increase in population and in business activity. As the smaller markets increase in size, it becomes more economical to serve them from nearby, rather than from distant, locations. Transportation costs are less because the products can be shipped a greater distance in carload quantities at carload rates. Selling costs also tend to be less in many instances, as will be noted in the following section in connection with the discussion of local wholesaling. For these reasons, most national wholesalers in recent years have either curtailed the territory in which they operate or have established branches that permit them to operate closer to the market.

District and Local Wholesalers. District wholesalers are located in large wholesale centers. They sell in their home city and in areas extending to as much as 400 miles from this city. Local wholesalers may operate in a large city, or in part of a large city, or in a small city and the cities and towns nearby. District wholesalers have advantages of large-scale operation similar to those of the general-line wholesaler, and they are likely to be predominant in the more sparsely populated areas. In many instances, however, they find the competition with local wholesalers very severe, and many have developed their own brands in order to meet this competition more effectively. Some have found that they can obtain business outside their local areas only at a high cost and have curtailed the areas served. Others have added new product lines in order to increase the size of orders and achieve economies of scale.

There are certain advantages in local wholesaling, especially in the marketing of staple lines. Staples are sold primarily on a price basis. This is particularly true in their wholesale distribution, for the retailer wants to buy such products at the lowest possible cost. Here the local wholesaler seems to have distinct advantages. The volume of sales is usually small and so the owners can retain direct control of the business, with none of the high administrative expenses for efforts directed solely to controlling a large organization. The local operator can keep in direct personal contact with his customers, thereby establishing a personal good will which makes selling easier; and he has personal knowledge of their credit standing. The salesmen of the local firm cover a small territory intensively and live at home most of the time, thus reducing their expenses. Delivery expense is likewise low, for the local wholesaler's warehouse is near his customers. This also enables him to make quick deliveries on short notice. Because of the modern emphasis on rapid stock turnover, this gives the local wholesaler a distinct advantage in selling to retailers, since his stock is nearer to the retailer than is the stock of the larger wholesaler whose headquarters are more remote. The local wholesaler can make most of his deliveries by truck, and any rail hauls from his warehouse to his customers are short.

THE WHOLESALER OF INDUSTRIAL GOODS

It was pointed out in Chapter 3 that industrial goods are often marketed directly from the producer to the business user. Purchasers often find it necessary to maintain direct contact with producers in order to keep abreast of the latest product developments in the field. Furthermore, in the purchase of many industrial goods even the largest buyers need technical assistance.

These objectives are likely to be best attained through direct relations with producers. And when sales of industrial goods are made on a large scale, as they commonly are, direct marketing is economically possible. Wholesale middlemen are important, however, in the marketing of a significant proportion of industrial goods; and, according to the data in Table 13-4 in the previous chapter, they may even be increasing in importance.

Types of Wholesalers

Attempts to classify the wholesale merchants of the industrial goods market are by no means satisfactory. Perhaps the best classification is one based on degrees and types of specialization. On this basis three major classes can be differentiated: (1) wholesalers who sell a wide line of supplies and equipment to many types of industrial goods buyers, (2) wholesalers who sell a single line of products to many types of industrial users, and (3) wholesalers who sell a more or less complete line to the industrial buyers in a certain industry or trade.[4] The wholesalers of the first type are commonly called "industrial distributors" or "mill-supply houses." The single-line wholesalers of the second class have no common name but are usually differentiated by using the line handled as a part of the name—as "paper wholesalers," "electrical-goods wholesalers," and the like. The third class, likewise, has no common name, although the type of business they serve is often used—as "oil-well supply houses," "dairy equipment wholesalers," or "dental supply houses."

Industrial Distributors. The industrial distributor sells a variety of products to many types of industrial buyers. The typical firm carries a wide line of equipment and supplies, which it purchases from numerous producers and sells to various buyers, but in the main to manufacturers. The principal functions of an industrial distributor are to fill small orders and handle emergency orders. Accordingly, well-assorted stocks must be carried. Large orders are likely to be sold directly by the manufacturer or filled by drop shipments.[5] In view of the emphasis on small and emergency orders, industrial distributors are most active within a geographical area in which delivery from warehouses can be made within a twenty-four hour period.[6] Most of their sales are made within the limits of a metropolitan trade area, although they also function

[4] The first two classes of wholesalers may be said to be selling in a "horizontal market," whereas the third class is selling in a "vertical market." For definitions of these terms, see note 7 in Chap. 3, p. 47.

[5] Drop shipments are those in which the order is taken by the industrial distributor or other wholesaler but shipment is made directly to the buyer by the manufacturer. The wholesaler takes title to the goods but not possession. Drop shippers are discussed further in Chap. 16.

[6] Stuart W. McFarland, "The Marketing Position of Industrial Distributors," *Journal of Marketing*, April 1953, p. 395.

as manufacturers' representatives in territories where the number of buyers is too small to warrant direct sale by manufacturers.

The number of industrial distributors is not known. Just which individual firms should be put in this class is not easily determined by ordinary census methods because of the great variation in the lines that are sold and in the operations carried on by individual firms. In 1948 there were 1,944 wholesale establishments designated as industrial distributors by the Bureau of the Census, with total sales of \$2,812,215,000.[7] Since 1948 the Census has not attempted to define or classify industrial distributors. The definition of an industrial distributor used in the 1948 enumeration was such that it undoubtedly included some firms that would not be properly classified, according to the definitions used here, as industrial distributors. On the other hand, some firms that might properly be classified as industrial distributors were probably omitted.[8]

Single-Line Wholesalers. There are many wholesalers that handle a particular product line for sale to many types of industrial goods buyers: paper wholesalers, chemical wholesalers, steel jobbers, electrical-goods wholesalers, office-equipment distributors, coal wholesalers, and many others. Their functions are not unlike those of industrial distributors, but they do not handle such a wide variety of products. The handling of small and emergency orders is an important function of most single-line wholesalers. In some cases, however, they may act as the exclusive agent for the lines of certain manufacturers. In these instances—the paper trade is a good example—large orders are handled by the wholesaler but shipped directly in carload lots from the manufacturer to the buyer. Thus the wholesaler may often act in the capacity of a drop shipper.

Many of these wholesalers are general-line firms but there is a good deal of specialization in some trades. Some paper wholesalers do the bulk of their business in a single line, such as wrapping paper, coarse papers, printing and writing paper, or stationery and stationery supplies. Chemical wholesalers may specialize in dyestuffs, explosives, industrial chemicals, or naval stores. Some steel jobbers specialize in structural steel, others in sheet-metal products, and still others in wire, wire fence, and wire rope. It is obvious that there may be many variations in the type of operation that is carried on. The same thing is true with respect to the territory covered. Many do a purely local business but others operate over a fairly wide area.

[7] *U.S. Census of Business: 1954*, Vol. III, *Wholesale Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 1–11.

[8] The definition of "industrial distributor" excluded machinery wholesalers and included dealers in materials, equipment, and supplies for mines, factories, oil wells, public utilities, and similar users.

Specialization by Type of Buyer. The third group of wholesalers mentioned above specializes in the sale of products to particular types of buyers. Among these are mining equipment and supplies wholesalers, oil-well supply houses, printing equipment distributors, dental supply houses, optical goods wholesalers, barber supply houses, and wholesalers of many other special lines. The characteristic feature of such firms is that they distribute a line of products to a particular class of customer. Usually they handle a rather complete line of the supplies and equipment related to the type of industry or profession served. Thus they become specialists in a particular type of industrial market.

In a number of these markets, it is evident that the market consists of an unusually high proportion of small buyers. Thus there is likely to be less direct selling by manufacturers and more reliance on the specialized wholesaler than is usually true in the industrial goods field. In other respects, their functions and services are similar to those of industrial distributors and single-line wholesalers.

Services of Industrial Goods Wholesalers

The services of wholesalers selling industrial goods need not be discussed in detail. These middlemen afford many of the same advantages to their customers and to the manufacturers whose products they sell as those offered by wholesalers of consumer goods to retailers and manufacturers. For the buyer, particularly the buyer whose purchases are made on a small scale, they select goods from among those offered by many competing manufacturers and store these goods where they will be ready for quick delivery. They often make deliveries free of charge and grant credit.

The industrial distributor is particularly useful to many buyers because of the wide lines that he handles. Even the larger buyers of industrial goods often purchase items which are used in small amounts and at infrequent intervals from such houses or from the more highly specialized types of wholesalers. The services of these distributors are also valuable when large buyers find themselves short of certain items because of errors in purchasing, delayed deliveries, or the receipt of unanticipated orders. Small quantities can be obtained quickly and are usually purchased more cheaply from the wholesaler's stocks, which have been bought and shipped from the factory at carload rates, than from the factory, which often sells such quantities at higher prices and with the added necessity of paying the higher less-than-carload freight or express rates for shipment.

Wholesalers in specialized lines, and even those that handle wider lines, are often well versed in the technical problems involved in the use of the goods they sell, and their salesmen are able to give valuable technical advice to their customers. Few purchasing agents can have a highly specialized knowledge of all of the products they must buy, and those firms which use a wide variety of products in the course of a year's operations frequently have no one in the organization who has specialized knowledge of some of those that must be purchased. New products and their uses are also brought to the buyers' attention by the wholesalers' trade paper advertising and direct mail efforts, and by his salesmen.

To many producers of industrial goods, the ready-to-use sales force of the wholesaler, his established clientele and knowledge of markets, his warehouse and delivery service, and his ability to pay cash and extend credit offer definite advantages. The manufacturer is often unable to provide these services at as low a cost as the wholesaler can, and limited financial resources may make it impossible for him to provide them at all.

CONCLUSIONS

It is evident from the foregoing discussion that the regular wholesaler has a definite and important place in the marketing system. There are other types of wholesale middlemen,[9] but generally speaking they do not constitute a serious competitive threat to the regular wholesaler. The principal source of competition, in fact, comes from the manufacturers' sales branch and other forms of direct marketing. The above average growth of the manufacturers' sales branch has already been noted in the previous chapter, but there is little statistical information as to the extent of other forms of direct marketing.

On balance, cost is the most important consideration in determining any middleman's place in the channel of distribution. There is evidence that manufacturers' sales branches in most lines operate with lower expense ratios than do regular wholesalers.[10] It may be noted, however, that manufacturers' sales branches probably are not charged with all the expenses that should be allocated to them. Of greater importance is the fact that such branches are most likely to be established when cost considerations are favorable and are likely not to be established when volume would be inadequate and costs excessive.[11]

[9] These middlemen will be discussed in Chap. 16.

[10] For a comparison, see Edwin H. Lewis, "Comeback of the Wholesaler," *Harvard Business Review*, November–December 1955, p. 117.

[11] Manufacturers' sales branches do operate on a much larger scale than do regular

The economic justification then for independent wholesalers is the fact that the use of their services lowers the cost of marketing. The way in which it does this has been pointed out briefly in the discussion of the services the wholesaler renders to manufacturer and retailer. When the services can be most economically performed by the wholesaler, it is evident that the possibility of selling to or buying from him must be seriously considered. Whether he will be used or not rests, however, not merely on his costs of operation, as evidenced by the margin for which he will handle products, but on the degree to which his performance of the marketing functions will satisfy those who are considering the use of his services.

It was pointed out earlier in this chapter that a primary service of the wholesaler is to supply the retailer with merchandise, that is, to assemble consumer goods, to divide and regroup these goods in the quantity and variety desired by retailers, and to have them ready to deliver when needed. It was also pointed out that most wholesalers handle thousands of different products. From this it follows that they can seldom devote any considerable amount of sales effort to the products of particular manufacturers. In fact, in choosing among the many products offered them for sale, they often refuse to handle the products of some manufacturers and handle only a part of those made by others. These considerations make the wholesalers' service more or less unsatisfactory to many manufacturers, and have thus been among the most important reasons which have caused some manufacturers to sell directly to retailers. This tendency has received further impetus from the fact that many retailers, likewise, prefer to buy directly from manufacturers. It has also been given impetus by the fact that some wholesalers manufacture some of the products they sell, and many wholesalers place their own brands on certain products which they buy from manufacturers. These conflicts will be discussed in more detail in the following chapter.

CASE PROBLEM—PRATT & WHITNEY COMPANY, INC.*

The Pratt & Whitney Company, a major manufacturer of machine tools, has always sold its line of cutting tools and instrument gauges directly to industrial users by means of its own sales force. The salesmen, who operate out of 18 branch

wholesalers. In 1958 the average volume per establishment was approximately $601,000 for regular wholesalers but more than $3,400,000 for manufacturers' sales branches. In view of the apparent effect of volume on the operating expense ratios of wholesalers, as noted in Table 13-5 in Chap. 13, it seems likely that the larger scale of operation is the basic reason for the lower expense ratios of the manufacturers' sales branch rather than any basic cost advantage that the branch might have as a type of operation.

* Adapted from an article in *Business Week*, March 19, 1960, pp. 59–60.

offices, are highly trained sales engineers. Some of their sales involve special-purpose tools designed to meet the particular need of a customer. In such cases, the salesmen may be required to make a highly technical analysis of the customer's manufacturing operation as a basis for the sale. Many of the company's products, however, are standard items which are produced to stock and sold to a variety of customers.

In March 1960, the Pratt & Whitney Company announced that it was discontinuing its policy of direct sale of cutting tools and instrument gauges and would proceed as rapidly as possible to select industrial distributors to handle the entire line. These distributors would be expected to stock a complete line of products, although slow-moving items still in production could be exchanged for other items. Sales assistance would be provided by Pratt & Whitney through its sales engineers, who would handle the more difficult technical problems. In addition, technicians would be available to assist in training distributor salesmen and from time to time accompany them on calls. All orders, however, even those from volume accounts, would be filled by the distributors. Moreover, no more distributors would be selected in each territory than necessary for full coverage.

Several considerations were involved in the decision to change the distribution policy of the Pratt & Whitney Company. In the first place, a large proportion of its customers apparently preferred to deal with industrial distributors, and in fact Pratt & Whitney was the only large firm in its field which was not using distributors in early 1960. In addition, the general sales manager stated that the company lacked breadth of distribution. Its sales force simply was not sufficiently large to call on all existing potential buyers. Not only were many potential customers completely overlooked, but the number of calls that could be made even on regular customers was limited. Moreover, the highly trained salesmen of Pratt & Whitney tended to spend their time working on the production problems of their customers and on the sale of special-purpose machines, thus neglecting the sale of the "bread and butter" lines.

The principal disadvantage involved in the change of distribution policy, in the view of the company, was the increase in distribution cost that would result. Industrial distributors would have to be given a discount of 20 per cent from the list price to the industrial user. Selling costs, under the existing method of distribution, were less than 20 per cent of sales, and many of the existing costs would continue to be incurred under the new system. However, the company believed that the alternative of expanding its own sales force would be even more costly, especially since traveling expenses would be greatly increased if the desired breadth of distribution were to be obtained. The company hoped to make up the increased cost of distribution through greater sales volume, through manufacturing economies resulting from longer production runs, and through reduced costs of carrying factory inventories.

Evaluate the company's decision and its reasons for making this decision. What problems may be encountered in effecting the change to industrial distributors? What alternatives might have been considered? What are the advantages and disadvantages of these alternatives?

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15. MANUFACTURER-MIDDLEMAN RELATIONS AND DIRECT MARKETING

Middlemen are used by manufacturers because they can perform the marketing functions more economically than can the manufacturer, because they can perform them more effectively at a given cost, because the manufacturer does not have the ability to perform these functions, or because he does not possess adequate financial resources to perform them effectively.

The first three of these considerations leading to the use of middlemen by manufacturers are based fundamentally on the marketing skills of the middleman and on his relatively low operating expenses. Because he is a specialist in a certain field of marketing operations, he possesses the intimate knowledge of his field and the skills that result from specialization; and because he commonly handles many products, he is in a position to benefit from the economies of operation that frequently result from marketing a large volume of goods to individual buyers or in a limited territory. The fourth point is also important. If the manufacturer does not have the necessary financial resources, he cannot market his own products effectively. The element of risk also arises in this connection. Direct selling involves certain fixed costs, such as the ownership of warehouse and delivery equipment. It also makes it necessary to hire and develop sales personnel. Such activities increase not only the financial resources required but the risk as well. If direct marketing does not succeed, the manufacturer's financial resources will be depleted, and in periods when sales decline expenses per unit of sales increase. But if middlemen are used, the risks arising from these contingencies are borne by the middleman.

It is safe to say, however, that many manufacturers, although they use the services of middlemen, are not completely satisfied with the results. Consequently, we find that some manufacturers supplement the middlemen's

services; others use middlemen for some of the marketing functions but perform other functions themselves; some have attempted to overcome the deficiencies of middlemen's efforts by selecting a limited number with whom they endeavor to build satisfactory relationships; others have entirely eliminated middlemen from the earlier stages of the marketing process or from marketing some products or from marketing to some customers or in some areas; still others do not use them at all.

MANUFACTURER-MIDDLEMAN RELATIONS

Relationships between manufacturers and middlemen vary greatly and there are many possible sources of conflict. Often the conflicts arise because of the lack of a common interest and the ease with which a particular agency can take independent action. But in other cases, conflicts arise despite the fact, or perhaps because of the fact, that the various agencies are dependent upon one another. Wholesalers and retailers often resent the attempts of manufacturers to suggest improvements in business methods. They dislike the establishment of sales quotas and requirements with respect to the carrying of minimum stocks. They fear a possible reduction in gross margins as the manufacturer assumes more and more of the marketing functions. Above all, they fear that the product will be taken away from them and sold directly by the manufacturer.

The difficulties between manufacturers and middlemen that often lead to the elimination of some or all of the services of middlemen arise most frequently out of the manufacturer-wholesaler relationship. The problems that arise here also exist, however, in one form or another in all manufacturer-middleman relations. In view of this fact, it will be helpful to study these problems in some detail. To make the discussion even more specific, chief attention will be given to the relations between manufacturers of consumer goods and the regular wholesalers who sell these goods to retailers.

Problems Involving Selling Activities

From the point of view of the manufacturer, the first and fundamental duty of the wholesaler is to sell his product. In considering the wholesaler's selling activities, however, it is important to bear in mind that his efforts are directed more toward providing retailers with satisfactory goods and services at satisfactory prices, and in building up a good will for his own services which will insure continued patronage by his retail customers. He succeeds only to the extent that he can sell to retailers at a profit. It follows

that he is more concerned with giving satisfactory service to them than in serving the manufacturers whose products he sells. Consequently, his efforts to create demand are directed primarily to this end, not to creating demand for the products of any particular manufacturer.[1]

The wholesaler's efforts to promote sales rest on two major decisions. He must first decide what products he will attempt to market. Then he must decide what amount of selling effort he will devote to each. His decisions as to what products to market, which of these he will place real sales effort behind, and how much sales effort he will devote to each are influenced by a number of considerations. Most important is the extent of the existing or prospective demand for the product. Products for which an active consumer demand exists and on which a satisfactory margin of profit is realized are looked upon with the greatest favor by the wholesaler, and by his retail customers. He prefers to sell such products, and if the prospective volume of sales is large he may actively promote their sale. But for some products for which there is an active demand the profit realized may be quite unsatisfactory. Even so, the wholesaler is usually forced to handle them in order to supply the needs of his retail customers, who will insist on buying them from someone. If the wholesaler does not supply them, they will be purchased from his competitors and he may be unable to retain his customers' trade in other products. Toward such products, however, the wholesaler is likely to be rather indifferent or perhaps even hostile. He not only refuses to push their sale, but he is likely to attempt to substitute competing products that can be sold at a more profitable margin. The great majority of products which the average wholesaler markets occupy a middle ground. He has them available for sale, but he undertakes no active effort to sell them.

If no large demand exists for a particular product in the wholesaler's territory but it appears that it can be sold without much effort on his part, or if the manufacturer has agreed to promote it in ways which the wholesaler believes will develop a demand, he is usually willing to stock it. If such a product offers a good margin of profit and shows promise of attracting a considerable volume of trade, he may be glad to devote some effort to its sale.

The presence of an existing demand, or the prospect of a demand to be developed by the manufacturer, is thus an important consideration in bringing about a decision on the part of a wholesaler to stock a particular product. These conditions do not of themselves, however, assure that the wholesaler will make any particular effort to sell it. The decision to devote real selling

[1] Although the discussion is framed with reference to the wholesaler of consumer goods, the reader should hold in mind that it is equally applicable to wholesalers of industrial goods and to retailers. In general, middlemen are more concerned with serving their customers than they are with serving manufacturers.

effort to a product must be carefully considered. Many competing products of the same kind are often handled. To promote one may merely result in diverting demand from similar commodities without increasing the total demand for that kind of product. It may be done at a disproportionate cost and may even result in sacrificing sales of other kinds of products which are necessarily promoted less intensively. If other wholesalers handle the same product, they may be the ones to benefit from the new demand which has been developed by the promoting wholesaler. The latter's sales and profits may or may not be increased. They may even decline.

Real sales effort can be expected by the manufacturer only when the wholesaler believes that his efforts will develop a demand on which he can realize a profit over a considerable period of time. The first and most important consideration in coming to a decision on this point is the gross margin of profit. It must be large enough to cover his immediate expenses of promotion and to convince him that his total net profit will increase and not decline, as a result of the fact that time devoted to the sale of one product limits the effort he can devote to the promotion of other desirable products. Next he must be assured that he will continue to realize a profit. If he is allowed to place his own brand on the product or if he is made the exclusive agent in his territory, he will feel more secure on this point. But many manufacturers desire to sell under their own brands and are unwilling to give exclusive agencies. Hence for such products, the wholesaler must be reasonably certain that, after he has developed a demand, the manufacturer will not decide to market directly or reduce the margin. On these points he can seldom feel assured. His decision must rest on his own judgment of what is likely to happen in each particular situation.

New products present a particularly difficult problem to the wholesaler. If the product under consideration is just a new brand of an existing commodity, of which he already has several competing brands in stock, he is likely to look upon it with indifference. The addition of such a product to his stock will tie up more capital while its sale may merely result in the reduction of sales of competing products. This is one of the most difficult problems facing wholesalers today. They often find that, with the constant addition of new competing lines, their investment is increased but not their sales volume, since customers are merely attracted away from old lines to the new ones. Even if a larger total demand for that particular kind of product results, the cost of creating the new demand may offset any increase in profits. It is difficult and often expensive to arouse interest in a new product, and the wholesaler's salesmen may not have the special knowledge and training required to sell it. So unless it appears that the product will be easy to sell, or

unless it offers a wider margin of profit than similar products of equal value, or gives promise of becoming a necessary addition to his line, the wholesaler is not likely to handle it. Even if he does decide to handle it, he will push its sale only up to the point at which he thinks the cost of additional sales effort is equal to the value of the resulting sales.

It follows then that if a product has real merit which is rather obvious, if it is of a kind which is in demand, if it allows a good margin to the wholesaler and the retailer, it will be well received. But if it is "just another product" for which no specific demand exists, or if it is a new kind of product for which a general demand must be developed, the wholesaler's efforts alone are not likely to prove successful. The manufacturer of such a product is often forced to develop a demand before the wholesaler will even consider stocking it.

Brand Problems and Conflicts

One result of the intense competition for sales has been the introduction of brands as a means of identifying the sources from which products are obtained. By branding the products he sells, the businessman makes it easy for those who have used and liked them, and those who have heard of them through his advertising and salesmen or from others who have used them, to identify his products when purchases are made. This makes buying simpler and more satisfactory, and helps the seller to realize more fully on his marketing efforts and the satisfaction consumers have derived from the use of his product.

Brands are widely used in a modern economy and are the cause of many difficulties between manufacturers and middlemen. The basic situation is admittedly an incongruous one. The manufacturer relies on middlemen to distribute his nationally advertised brands. At the same time, the manufacturer sells unidentified products to wholesalers and large retailers who resell these products under their own brand names.[2] The middleman who is supposed to distribute the brands of manufacturers thus also handles his own brands and sells them in competition with the brands of manufacturers. It is obvious that a conflict of interest exists in this situation, both on the part of the manufacturer and on that of the middleman.

The Manufacturer's Viewpoint. It has long been a common practice for manufacturers to sell unidentified products to wholesalers, mail order houses,

[2] Brands of manufacturers are often called "national" brands and those of middlemen "private" brands. We shall use here the more accurate terms, "manufacturers' brands" and "distributors' brands."

chain stores, large independent retailers, or even to other manufacturers who resell the products under their own brand names. Some manufacturers who sell products under their own brand sell a part of their output to middlemen for resale under the middleman's brand. This last practice seems to have become more common in recent years. The growth of various types of large retail organizations which desire to sell products under their own names has contributed to this development, as has the desire of wholesalers to secure the advantages of branding and to protect their own business from the branding efforts of both manufacturers and retailers.

Manufacturers who, in addition to selling their own branded products, also sell products to be marketed under the brands of wholesalers and retailers are producing commodities which will compete with their own brands and which frequently sell for lower prices at retail.[3] Some manufacturers who do this originally sold their entire output to branding middlemen. Selling under their own brands has been a later development designed to strengthen their position in the market, to develop a market which makes it possible to utilize surplus plant capacity, or both. Other manufacturers began to produce products to be sold under distributor brands after developing a market for their own branded products. It may seem to be unwise thus to assist in the development of competing brands, but it is not necessarily so and is not always easy to avoid. Many such manufacturers have surplus plant capacity which these sales make it possible to utilize. Others undertake to make such sales because they realize that if they do not some other manufacturer will. If they take the business themselves, it adds to their volume and may prevent an enlargement of production capacity by other manufacturers which will ultimately make competition more severe.

The Wholesaler's Viewpoint. Wholesalers have long branded many of the products they handle, but the increasing importance of manufacturers' brands which developed out of large-scale manufacturing and selling methods gave them further reasons for using their own brand names. The growing strength of manufacturers' brands, and particularly the attempts of manufacturers to supplement the wholesalers' selling efforts by sending salesmen directly to retailers, has resulted in a substantial threat to the wholesalers' position. This threat is manifested in several ways.

[3] "By and large, however, the private branders cannot be credited with bringing product innovation and progress in merchandise. With relatively few exceptions they have been imitators and have benefited from the building of demand for various types of differentiated merchandise by manufacturers. They have not incurred the growth costs which some manufacturers have, but they enter with a price appeal when demand has been built. In so doing they provide a check against manufacturers retaining permanently the benefits of successful pioneering in merchandise." Neil H. Borden, *The Economics of Advertising* (Homewood, Ill.: Irwin, 1942), pp. 605–6.

One of these is the possible effect on margins. Manufacturers who sell branded products for which a strong demand has been developed may take advantage of the good will which inheres in their brands to reduce the margin realized by the wholesaler. If the latter, on the other hand, has established his own brands he is in a better position to resist such acts, as well as to gain the same kind of good will for his own products.

The right and wrong involved in a margin reduction is not always evident. The manufacturer sometimes claims that, through performing the function of demand creation himself, he has taken over one of the greatest expenses which the wholesaler's margin is presumed to cover. For performing this function, the manufacturer insists that he is entitled to that part of the wholesaler's margin which covers this expense. Apparently this is a question of fact. If the manufacturer does create the demand, he surely should not pay the wholesaler for doing so. Whether he takes advantage of his power in the market to exact even more than this cannot be readily ascertained in most cases. Although it seems improbable that many manufacturers have created a consumer demand strong enough to overcome the wholesaler antagonism which such a price policy would involve, the fact that a few large manufacturers have done so makes the wholesaler suspicious of all similar selling efforts. If he thinks the manufacturer is allowing too small a margin, or if he fears that the margin will ultimately be cut, it gives rise to as much ill will in the relations between them as though it were the actual fact.

Another argument advanced by the manufacturer when his product must be handled on a small margin is based on the contention that it has a more rapid turnover than the less well-known brands of the wholesaler or of other manufacturers which may show a larger margin per unit of sale. Since his product is in great demand, he contends that a given investment in stock nets a larger volume of sales. This again is a question of fact which will vary with individual manufacturers' products and even with individual wholesalers. Some distributors' brands are better known than those of many manufacturers. Even in such cases, the manufacturer may contend that the wholesaler has to stock his own products in large amounts because he is the source of supply, whereas he can often carry small stocks of the manufacturer's products and obtain new supplies quickly from the manufacturer's stocks in a nearby branch or public warehouse. This again is a situation which will vary greatly. No adequate facts are available on which any broad generalization can be based.

Another threat to the wholesaler is the possibility that, after he has spent time and money in building up a demand for a product, the manufacturer will decide to sell to retailers himself; or, if the wholesaler has an exclusive

agency for the product in his territory, he may fear that the manufacturer will turn his product over to another wholesaler or open the territory to competing wholesalers. Since the product is branded, the wholesaler will lose all the business he has developed for it if another wholesaler is given exclusive rights or if the manufacturer decides to sell it himself; and if his territory is opened to competing wholesalers he fears that his volume of business will be reduced. On the other hand, he reasons that if his efforts are applied to a product bearing his own brand or to improving and selling his service to retailers, he will develop a permanent trade and good will. Hence, if he is to introduce a new product, he may prefer to have it under his own brand. But this in turn may create ill will on the part of manufacturers of competing products which he is also selling, and perhaps hasten the severance of business relationships with them. Even though the wholesaler has expended little or no time and money in demand creation, he still must face the loss of business when a branded product is taken from him or its sale is divided with other wholesalers. For, although the manufacturer may have taken the entire burden of creating the demand, when he takes the product away from the wholesaler sales are lost which may prove difficult to replace.

There are also more positive reasons for the distributor's desire to sell his own private brands. Among these is his desire to sell a large volume of certain products for which there is a brisk demand at profitable prices. Realizing the advantages of creating demand for his own products, the distributor has seen that he may develop a more stable and permanent business by promoting brands which only he can sell. Other reasons for the introduction of distributors' brands could be cited, but they do not seem to be necessary at this point. It is obvious from the preceding discussion that the brand problem is a substantial one and that it has greatly affected manufacturer-middleman relations.

Problems Related to Other Marketing Functions

The desire of the manufacturer to have his products sold more effectively has been the paramount cause of most changes in the relations of wholesalers with manufacturers, but reasons connected with the performance of other marketing functions have also influenced these changes and have sometimes been their chief cause. The storage and delivery service performed by wholesalers is now less essential to manufacturers in general than it has been in the past. The development of merchandise warehouses gives many manuturers another means of supplying spot stocks to dealers and large consumers, and the development of motor truck transportation as well as improved rail

service has made possible more rapid deliveries from the manufacturer's own factory or branch, and from the public warehouse. The development of larger retail establishments has increased the possibility of direct carload shipments, and the increasing concentration of retail trade in large towns and cities enables manufacturers to reach a large volume of trade from given points to which they ship in carlots. But the ability of the wholesaler to make rapid delivery of small lots of merchandise to retail stores remains an important service in the marketing of many manufacturers' products.

Another important service performed by most wholesalers is financing. This takes the several forms previously enumerated: advancing funds to manufacturers or assisting them to obtain funds; buying and paying for goods to be held in storage until sold; guaranteeing collections—if goods are drop-shipped; and attending to credits and collections with the retail trade—a service that naturally follows from the fact that the wholesaler buys the goods he sells. These financial operations of the wholesaler have become less and less important to many manufacturers. In the earlier development of the factory system, manufacturers were commonly financed by wholesale middlemen. But as industry has developed, manufacturers have become stronger financially, until today the wholesalers' assistance in financing production has become relatively unimportant and manufacturers are quite generally financing their own production needs.

Today the wholesaler's purchase of goods for stock and the service he renders in collecting from the retail trade constitute his principal financial functions. But these, too, have become less important. For not only are manufacturers better able to finance the holding of stocks and the granting of credit to retailers, but problems of credits and collections have been simplified. In the first place, retail business is now more highly concentrated as a result of the growth of towns and cities and metropolitan areas and the decline of small trading centers in country districts. In the second place, general and specialized credit rating bureaus now furnish credit data which the manufacturer formerly depended on his middleman connections to supply. And in the third place, a much larger share of many manufacturers' sales are made to large retail units. Credits and collections are more economically handled when the bulk of one's business is done with large buyers concentrated in metropolitan areas. Such activities have been rendered still more economical as a result of a tendency for individual manufacturers to produce and sell wide lines. Retail credits and collections for pickles alone, for example, would be expensive for a manufacturer to handle, but sales of the Heinz line of food products to a single store, even to a small store, make up a sizable order over which this expense is spread.

Attempted Solutions of Manufacturer-Wholesaler Problems

Wholesalers and manufacturers have resorted to many devices to improve their individual positions. Some of these have led to closer cooperation in manufacturer-wholesaler relations, but others have pointed in the opposite direction. The wholesaler has found that some items, such as electrical appliances, can be sold in such large volume that he can specialize in the sale of one manufacturer's line of products, or in the sale of the products of a very small number of manufacturers. Although most wholesalers have not developed such a high degree of specialization, many have, nevertheless, considerably reduced the number of lines they carry. In such cases, they gain the advantages of specialization and find it possible and necessary to push the sale of individual manufacturers' products more intensively in order to obtain an adequate volume of business. Some wholesalers have become limited-function middlemen, and by reducing the services they render have been able to reduce their expenses. Others have developed chain store systems or sponsored voluntary chains of independent retailers, in part to strengthen their bargaining position with manufacturers and in part to meet the encroachments of chain stores on their business.

Many wholesalers, as we have seen, brand some of the products they sell in order to build up a demand of their own. The use of distributors' brands, however, is probably not so widespread as is sometimes assumed. Such brands are of greatest significance in the sale of food products.[4] They are used, but their use is limited, in dry goods, drugs, and hardware.[5] Thus many middlemen are willing, and even anxious, to feature manufacturers' brands and to cooperate with manufacturers in the promotion of them. Actually, the successful development of an important demand for distributors' brands usually involves expensive promotional efforts, efforts which the average wholesaler is either unwilling or financially unable to make.

The fact that there are wholesalers available who are willing to cooperate with manufacturers has led the latter, in a number of instances, to re-examine

[4] It is difficult to find out what the situation actually is. The A. C. Nielsen Company states that manufacturers' advertised brands have obtained during the fifties, with little variation from one year to another, about 75 per cent of the volume in 38 food groups checked by that company. See *The Battle of the Shelf*, report of an address by J. O. Peckham, A. C. Nielsen Company, 1959. *Time* magazine has reported, however, that distributors' brands—including those of large retailers—increased their share of the market between 1956 and 1959 in a number of grocery lines. Examples cited are instant coffee from 12 per cent to 31 per cent of the market, frozen vegetables from 38 to 53, and oleomargarine from 58 to 71. See issue of June 15, 1959, p. 88.

[5] Edwin H. Lewis, "Comeback of the Wholesaler," *Harvard Business Review*, November–December 1955, p. 122.

their distribution policies. In some cases, this has led to decisions to place greater reliance on wholesalers.[6] Especially is this the case when manufacturers have developed means of cooperating with wholesalers in their mutual sales efforts. These may include activities directed toward the sale of the products to retailers, to consumers, or to both. Advertising their products to retailers and consumers is the most familiar of these activities. But some manufacturers send out salesmen to place display material in retail stores or even to solicit retail orders to be turned over to the wholesaler to fill. Again, cooperation may take the form of help in training wholesale salesmen to sell the particular manufacturer's product. This is done in several ways: (1) by sending letters or bulletins to the wholesaler or his salesmen, (2) by lectures delivered to the wholesaler's salesmen occasionally or at regular intervals, and (3) by sending the manufacturer's salesmen to call upon customers with the wholesaler's salesmen. Such cooperation is obviously limited in its application. In the first place, the wholesaler must be willing to accept it. He must be convinced that he will benefit from it. Moreover, the wholesaler's salesmen must be willing to be trained, and induced to put their training to use in the sale of the manufacturer's particular product or line.

In view of the large number of products handled by most wholesalers, any substantial use of the various devices manufacturers have developed for cooperating with them is obviously impossible. Efforts to use them all would not be profitable. If they were used for large numbers of products the advantages would be minimized or completely eliminated. Thus many manufacturers do not make the attempt. Moreover, such work is expensive and many manufacturers cannot finance it. If he is in a position to finance it, a manufacturer may believe that his money can be better spent in taking over all of his selling, or even all of his marketing, than in attempting to cooperate with wholesalers who may be unable to give what he considers adequate help in pushing the sale of his products.

The final step taken by the manufacturer who does not believe that merchant middlemen can or will effectively market his product is to do the job himself. In the case of the manufacturer of industrial goods this usually means direct sale to the users of his products, although it may mean the employment of agent middlemen instead of wholesale merchant middlemen. In the case of manufacturers of consumer goods, this commonly means direct sale to retailers. A few manufacturers of consumer goods, however, avoid all

[6] See, for example, the decision of the Scott Paper Company to sell its industrial packaged goods entirely through wholesalers. "Scott Banks on Its Distributors," *Business Week*, April 27, 1957, pp. 73 ff.

middlemen and sell directly to final consumers. The problems involved in the direct marketing of manufactured products are discussed in the next section.

DIRECT MARKETING OF MANUFACTURED PRODUCTS

Direct marketing merely means that the producer undertakes to market his products without the use of intervening middlemen. That is, he "eliminates" or "circumvents" the middlemen. A complete system of direct marketing would involve the sale of industrial goods directly to the business, governmental, or institutional user and the sale of consumer goods directly to the ultimate consumer. Since manufacturers of consumer goods do not usually sell directly to the ultimate consumer, the term "direct marketing" is customarily used to include sales by manufacturers to retailers. Any element of confusion thereby introduced can be avoided by adding a clarifying phrase when necessary—direct to user, direct to ultimate consumer, or direct to retailer.[7] The emphasis in the present discussion will be on the circumvention of the wholesaler.

Reasons for Marketing Directly

The basic reasons for direct marketing are (1) the increasing pressure of the manufacturer for sales volume, (2) the inadequacy of the services of middlemen, and (3) the desire of buyers to purchase directly.

Pressure for Sales Volume. One of the important reasons for direct marketing is the increasing pressure on the sales department which has resulted from the need to find markets for the products of large-scale manufacturing. The generally keen competition for sales and the necessity of developing markets for new products have led manufacturers to place more and more emphasis on the use of aggressive selling methods. The importance of selling and the difficulties manufacturers frequently face in obtaining a satisfactory volume of sales at profitable prices make it necessary for them to look critically upon existing marketing arrangements.

We have already seen in the previous chapter that many wholesalers are not in a position to give aggressive selling support to the products of any one manufacturer. In view of this fact, it is a rather common belief of manufacturers that wholesalers do not devote enough time and do not provide adequately skilled selling efforts to obtain the volume of sales required or de-

[7] This is recommended by the Committee on Definitions of the American Marketing Association. See *Marketing Definitions* (Chicago: American Marketing Association, 1960), pp. 11, 12.

sired by the manufacturers. Even those manufacturers who have already undertaken a part of the selling operation often feel that their wholesalers do not supplement those efforts to their satisfaction. Thus decisions to market directly are probably made more often for this reason than for any other: that the manufacturer can provide a more aggressive selling effort than can the middleman and that this will result in a greater volume of sales.

Inadequacy of Middlemen's Services. Sometimes the decision to market directly is based on the refusal of the middlemen to carry adequate stocks and parts or to give satisfactory repair service for electrical and mechanical devices. Manufacturers normally expect middlemen to handle their complete lines and to carry adequate stocks of all items; but middlemen often prefer to stock relatively small qauntitics of some items, and they may refuse to handle a part of the line at all. The problem of providing satisfactory repair service for household appliances has been a particularly difficult one in recent years, resulting in the establishment of service centers by manufacturers and less reliance generally on middlemen for the performance of this and other marketing activities.

Sometimes middlemen refuse or are unable to furnish acceptable storage and delivery services for perishable commodities. This has been an important factor, for example, in bringing about the direct marketing of yeast to bakeries and retail stores, and has influenced the meat packers to undertake direct marketing to retailers. Again, the middleman may refuse to follow the price, discount, and credit policies recommended by the manufacturer.[8] Finally, the manufacturer may feel that the margin or commission that the middleman realizes on the sale of his product is not warranted by the services rendered. In a large number of cases, some one consideration looms above all others as the determining factor, but the final decision to market directly is frequently based on a combination of some or all of the reasons just summarized.

Buyers' Desire to Purchase Directly. In the marketing of both consumer and industrial goods, an increased scale of operations has enabled many buyers to devote more time to buying and to purchase in large enough volume to make more direct marketing methods worthwhile. Large retail organizations, such as the chain systems, large department stores, and the mail order houses, prefer to buy directly from manufacturers and perform the wholesaling func-

[8] With the breakdown of many state "fair trade laws" in the late fifties, the problem of getting wholesale distributors to follow the manufacturers' recommended price and discount policies became an important one. Sunbeam Corporation began to experiment with a plan which would retain distributors but on an agency basis. By not permitting distributors to take title to the merchandise, Sunbeam retained control over wholesale selling prices. Schick, on the other hand, began to eliminate its 1,200 distributors in favor of direct sale to dealers. See *Business Week*, December 20, 1958, p. 87, and February 14, 1959, p. 64.

tions themselves. And other retailers, such as the retailers of fashion goods, even when operating on a relatively small scale, find it to their advantage to establish close connections with their sources. Similar influences, including the desire of companies using technical products to work directly with the manufacturers who supply their needs, and the tendency of many institutions and governmental agencies to purchase directly from manufacturers, have resulted in closer manufacturer-user relations in the marketing of industrial goods. Many of these organizations insist on purchasing directly. When faced with this situation, the manufacturer, regardless of his own desires, must sell to such buyers directly or not at all. If they constitute a large proportion of his market, he may decide to take over the marketing of his entire output.

The Justification for Using Middlemen

There is a rather general failure to realize that goods are not necessarily marketed more cheaply when middlemen are not used. To "market directly," to "eliminate" or "circumvent" the middleman, are phrases which to the uninitiated connote the elimination of steps and services in marketing which will inevitably result in reducing expenses and saving profits that would otherwise accrue to the "eliminated" middlemen. This false notion arises from the common failure to realize that middlemen exist because of the economies they effect in marketing, that specialization and division of labor bring economies in marketing as well as in production.

Functions Must Be Performed. It should be made clear at the outset that a decision not to use any or all classes of middlemen that could be used in marketing a product does not mean that the marketing functions such middlemen perform are no longer necessary. Buying and selling must go on, stocks must be stored and transported, and the other functions must be performed by someone. On the other hand, experience has proved that direct marketing may result in an improvement in the performance of the functions, which in turn may result in improved service to buyer or seller or both and may also result in a reduction in expense. From this brief statement, it appears that the crux of the direct marketing decision in any given case revolves about the question of whether the necessary marketing functions can be most satisfactorily performed by middlemen, who are specialized independently controlled agencies, or by integrated organizations in which specialists are not necessarily eliminated, but in which they operate under the control of a central management.

Cost Advantages of Middlemen. It is evident that the manufacturer who decides to sell directly, or the large retailer who decides to buy directly, will

become involved in additional marketing activities and will incur additional costs. For illustration, let us take the case of the manufacturer who has been selling to wholesalers but who now decides to sell directly to retailers. Whereas he formerly found that a few salesmen could sell to wholesalers, he must now add to his sales force in order to sell to the much larger number of retailers. Whereas he may have been able to supply the wholesalers from a factory warehouse, he must now develop a warehousing service that will enable him to satisfy his new retail customers. This will usually involve the purchase or lease of warehouse space at enough points to enable him to deliver small orders on short notice just as the wholesaler did. Whereas he could ship in relatively large amounts, usually in carloads, when he sold to wholesalers, he must now be ready to deliver many more orders to his retail customers, usually in much smaller amounts and on much shorter notice. His performance of other functions, particularly his assumption of retail credits and the additional risks resulting from the extension of his marketing activities into the wholesaling field, is likewise more extensive. Very often such direct marketing makes it necessary to set up a rather complicated sales organization, divided and subdivided on a territorial basis, with branches which serve as sales headquarters for the salesmen who call on the retailers. These branches may also carry stocks, make deliveries, and supervise local credits.[9]

The fact that the manufacturer must incur additional costs when he markets directly does not necessarily mean that these costs will exceed the gross margin obtained by the wholesaler. But wholesalers do have a cost advantage in many instances. The reason for this is that the wholesaler markets many products whereas the manufacturer normally distributes only his own output. The wholesaler's cost of sending a salesman to call on a retailer can be allocated over many products and does not bear heavily on any one. The corresponding cost of the manufacturer must be absorbed normally by the relatively few products produced by him. Warehousing space can ordinarily be utilized more efficiently by the wholesaler since the "peak-load" need for space can usually be solved by dovetailing seasonal lines. Credits and collections can be handled more efficiently since only a single operation is necessary in investigation and billing despite the fact that hundreds of products may be involved. Thus the wholesaler may have a substantial cost advantage. In

[9] The illustration used here is one of forward integration in which a manufacturer takes the responsibility for the wholesaling functions. As previously mentioned, large retailers often assume this responsibility, i.e., engage in backward integration. The same general points may be made with respect to the performance of wholesaling functions by retailers as by manufacturers, except that retailers are not likely to engage in wholesaling activities unless they see definite cost advantages. Manufacturers, however, may be willing to incur added costs in order to achieve other advantages. See also the discussions on integration in Chaps. 2 and 9.

fact, most small manufacturers, and many large ones, find the costs of direct marketing to be prohibitive.

Conditions Favoring Direct Marketing

Direct marketing by manufacturers then is most likely to take place when certain conditions exist. These conditions are: (1) suitable middlemen are not available to handle the product, (2) the attitudes of competitors and buyers are such that direct marketing is required, (3) the manufacturer has adequate managerial ability and financial resources to market directly, and (4) the manufacturer is in a position to perform the marketing functions at a reasonable cost.

Availability of Middlemen. One of the more important considerations leading to direct marketing is the availability of suitable middlemen and the character of service they can be expected to perform in the sale of a manufacturer's products. It has already been pointed out, for example, that wholesalers who market the kind of products a given manufacturer produces may refuse to handle his particular product, or may not be able or willing to render the quality of service he desires. Very often, however, suitable middlemen are not even available, or they are so closely associated with competitors that the manufacturer hesitates to have them undertake the marketing of his products even though they are willing to do so.[10] The first manufacturers of many products, such as harvesting machinery, typewriters, adding machines, mechanical refrigerators, radios, automobiles, and airplanes, for example, faced a market in which no existing middlemen were handling such products, and very often no existing middlemen appeared to be capable of marketing them. Such manufacturers faced the alternative of developing suitable middlemen or marketing their own products. Some undertook to develop a satisfactory group of independent middlemen. Others undertook to market directly to users or to retailers. Late comers in these and other fields may also find no suitable middlemen available. In some instances this is because the best of the existing middlemen are marketing competitors' products under exclusive arrangements. If they are not working under exclusive agreements, they may nevertheless have such close relationships with particular manufacturers or handle so many competing products as to preclude the possibility of their selling another product in a satisfactory manner.

Attitudes of Competitors and Buyers. Two other considerations are often of great importance. One is the nature of competition; the other is the atti-

[10] For a discussion of this point with respect to the marketing of electrical appliances, see "Branch Distribution Trend Gains," *Business Week*, September 10, 1960, pp. 65–8.

tude of buyers. Competitors may be unimaginative and conservative, or they may be imaginative and aggressive. If they are imaginative and aggressive, direct marketing by them may call for direct marketing by others who would successfully compete with them. From the buying side, likewise, there may be forces that call for direct marketing. We have seen that many important users of industrial goods and many important retailers who purchase consumer goods for resale desire to purchase directly from manufacturers. If these buyers are insistent in their demand for direct purchase, they must be sold in that way, and this may lead the manufacturer to sell directly to all purchasers.

Managerial Ability and Financial Resources. Even though the manufacturer may *desire* to market directly, for the reasons given previously, it is not always *possible* for him to do so. There are other conditions which are essential to success in direct marketing. Two of these are a high quality of managerial ability and adequate financial resources.

When a firm decides to market directly, it is evident that new administrative problems must be solved and that marketing knowledge and skill must be provided. Risks will be increased and additional funds will be needed. Thus any given firm's decision on the question of direct marketing will be greatly influenced by its estimate of the ability of its management and the adequacy of its financial resources. Under fundamentally similar conditions of cost, the ability of the manufacturer as a merchandiser and his financial resources often determine the extent to which he will utilize his own efforts rather than depend on those of the wholesaler. The personal ability of management is of the utmost importance in determining the marketing methods used by individual firms, and is a frequent reason for the use of different methods for marketing similar products under apparently similar conditions. Where one man will boldly launch a direct marketing campaign and succeed, a second will launch forth as boldly and fail; while a third, having less imagination and initiative or less confidence in his own ability, will not even make the attempt. The type of managerial ability that will be of paramount importance is, of course, knowledge of and experience in the particular marketing operations that must be undertaken. Many firms do not have the type of managerial ability required. They may or may not be able to employ it.

Many firms likewise do not have adequate financial resources to meet the added expenditures that will be involved, such as the need to increase their advertising, add to their sales force, carry an investment in larger stocks, expand warehouse and delivery services, expand their credit facilities, and bear the added market risks that result from enlarged marketing operations. Some part or all of the investment in facilities and the expense of their opera-

tion, which is borne by wholesalers when their services are used, must be provided by the manufacturer when he markets directly. Hence, even when financial resources are available, it must be recognized that total fixed costs for facilities and operation will be increased. These cannot be rapidly reduced when total sales decline or when sales decline in some part of the market area. Branch offices, warehouses, delivery equipment, and excess marketing personnel usually must be retained for a considerable period of time after sales have fallen off.

Cost Considerations. Fundamental to all considerations relating to direct marketing is cost. The wholesaler's services are expensive to perform, but they must be performed. Unless the manufacturer can improve the method of their performance so as to reduce the expense, or increase sales, or make an adequate volume of sales at higher prices, there is no point in his undertaking them. This means that the expense and results of using any particular method of marketing must be balanced against the expense and results of alternative methods.[11] Thus, in considering whether to market directly, the expense of doing so must be balanced against margins which would be allowed to wholesalers for achieving the same results. As a rule the decision turns on unit costs of marketing. This in turn rests on the volume of sales that can be made for a given expenditure.

Marketing costs per dollar of sales tend to be low when a manufacturer sells in large volume to individual buyers. Large orders are common in the sale of important fabricating materials, parts, accessories, and supplies. Many shoe stores, likewise, handle a single manufacturer's shoes exclusively or in large volume. Men's clothing stores often sell large volumes of a given manufacturer's clothing. The same situation prevails in the sale of automobiles, trucks, tractors, and farm machinery, and in many lines of household equipment such as heating equipment, mechanical refrigerators, gas and electric ranges, which are sold in large volume to individual retail stores. In all such cases the volume of sales made to a single purchaser is large, frequently large enough to reduce the cost of selling and other marketing expenses to a percentage of sales that makes it possible for the direct-marketing manufacturer to compete successfully with manufacturers using wholesale middlemen.

A similar relationship of expense to sales prevails when the price of a single product or purchase amounts to a large sum, as in the sale of expensive machinery. Manufacturers who are able to sell a wide line of products to a single buyer are in a similar position. In fact, their wide lines tend to give

[11] There is, of course, the possibility that the wholesalers are making large profits which the manufacturer hopes to realize himself. But the wholesaler's profits are seldom large enough to warrant the manufacturer in undertaking to market his own products simply to obtain those profits for himself or to pass them on in price reductions to his customers.

them the same economies that are realized by the wholesale middleman who handles a wide line of products. True, the manufacturer's line is seldom so large as that of a wholesaler who is selling to the same class of buyers, but by concentrating on the sale of his own products the manufacturer is frequently able to make sales in large enough volume to attain a sufficiently low percentage of expense to sales. Familiar examples are the meat packers, National Biscuit, and General Foods, although the fact that these particular firms usually have a large number of customers in a small area is perhaps of equal importance.

As a final example, we may cite those manufacturers whose sales to individual buyers are commonly made in rather small amounts, but who sell to many buyers in a compact area. The salesmen of such manufacturers can often make a large volume of sales in a short time, and deliveries and other marketing operations can be concentrated so as to reduce the cost per customer. Distributors of milk and related dairy products and such vendors as Stanley Home Products, the Fuller Brush Company, and the Jewel Tea Company and other retail truck distributors of grocery products even find it possible to sell and deliver their products directly to consumers. The refiners of gasoline and oil, the manufacturers of automobile tires and related products, and many other manufacturers can sell directly to retailers for this reason. Other firms, including some manufacturers of shoes, clothing, paint, tires and accessories, and petroleum products, sell a considerable proportion of their output through their own retail stores; and many manufacturers of industrial goods, such as typewriters, business machines, and shop machinery and equipment, find that the presence of a large number of buyers in a given business or industrial area makes it possible to market directly to users at a cost low enough to make their direct-marketing operations profitable.

In brief, direct marketing is economically feasible when a single buyer purchases large quantities of a single product, a wide line of products, or single products of great individual value, or when the existence of a large number of buyers in a compact area makes it possible to market a large volume at a small cost per dollar of sales.

On the other hand, when products are sold in very small volume to individual buyers, and particularly when such purchases are infrequent or buyers are widely separated, the expense of marketing consumer goods directly to consumers or to retail stores, or marketing industrial goods directly to users, becomes too high to warrant the attempt. Selling costs per dollar of sales increase, delivery expenses increase, adequate stocks cannot be carried at enough points to give the service buyers demand, credits cannot be adequately supervised—middlemen are necessary.

Wholesalers' Efforts to Reduce Costs

In recent years, wholesalers have done much in an effort to maintain their position in the marketing structure.[12] They have cooperated to a greater extent with manufacturers in efforts to sell the latters' products. At the other end of the channel, they have worked more and more closely with retailers to assist them in maintaining efficient operations and especially in selling products to the final consumer. Above all, wholesalers have attempted to increase the efficiency of their operations and to reduce operating costs.[13] These efforts at cost reduction have been made with three objectives in mind: (1) to make it less attractive for the manufacturer to market directly, since cost is likely to be a determining factor in his decision, (2) to make independent retailers more competitive with chain stores by providing them with merchandise at as low a cost as possible, and (3) to obtain a competitive advantage in relation to other wholesalers.

These efforts to reduce costs have taken many forms. For example, grocery wholesalers have now generally adopted the printed order form which arranges the individual items in such a way as to provide for the most efficient handling of orders in the warehouse. Duplicate order forms have been eliminated and the office work necessary in connection with orders and invoices has been greatly reduced. In some cases, salesmen have been eliminated and services have been curtailed. Many grocery wholesalers now sell only for cash and restrict deliveries of merchandise to retailers to one per week, that one being available only on a specified day of the week.

Warehouse operations of most wholesalers have been greatly improved in efficiency also. Multistory operations are gradually being replaced where possible with single-story buildings that permit a more rapid and more mechanized handling of stock. Substantial advances have been made in the design and use of automatic handling equipment.[14] Electronic machines have

[12] For detailed discussions, see Edwin H. Lewis, *op.cit.*, pp. 115–25, and various trade articles such as "The New Look in Wholesaling," reprinted from *Hardware Retailer*, May 1958.

[13] Some of the earlier studies made by the U.S. Department of Commerce, usually in cooperation with wholesale trade associations, which were instrumental in calling the attention of wholesalers to problems of operating efficiency are as follows: W. H. Meserole and Charles H. Sevin, *Effective Grocery Wholesaling*, Economic Series No. 14, 1941; W. H. Meserole, *A Study of Tobacco Wholesalers' Operations*, Industrial Series No. 62, 1946; John R. Bromell, *Effective Use of Wholesale Drug Warehouses*, Industrial Series No. 68, 1947; and John R. Bromell, *Dry Goods Wholesalers' Operations*, 1949.

[14] See, for example, R. M. Winslow, "Automation in Food Wholesale Distribution Centers," and discussion by Raymond H. Scott, in Robert D. Buzzell (ed.), *Adaptive Behavior in Marketing* (Chicago: American Marketing Association, 1957), pp. 41–52; also "The Push Button Warehouse," *Fortune*, December 1956, pp. 140 ff.

even been developed that will fill an order in a few seconds, thus both decreasing costs and improving service.[15]

In general it may be said that wholesalers have begun to study their operations seriously, and many advances in operating efficiency may be expected in the future. If the wholesaler can at the same time increase his selling efficiency, an area in which he has made much less progress, there will be less and less reason for the manufacturer to undertake a direct-marketing program.

QUESTIONS FOR DISCUSSION

1. It is frequently claimed by manufacturers who sell directly to consumers, either house-to-house or through their own retail stores, that they have eliminated the middleman and the middleman's profit and thus are able to sell to the consumer at lower prices than those charged by regular retailers. In many cases, their prices do appear to the consumer to be below those of competitors even when differences in quality are taken into account. How much validity do you think there is in this claim that prices are lower because the middleman has been eliminated? Assuming that these manufacturers do give better values than many of their competitors, how would you account for this fact?
2. SKF Industries, Inc., a large manufacturer of ball bearings located in Philadelphia, announced in 1960 (see *Business Week*, July 23, 1960, pp. 114 ff.) that it would henceforth provide for its 300 distributors without charge a complete management consulting service. Distributors would be able to obtain assistance regarding any operating or management problem "from insurance and taxes to recruiting and publicity," according to the announcement. The assistance would be furnished by the staff members of SKF on the same basis that they give assistance to SKF's own departments. Thus, under these arrangements, press releases and publicity brochures have been prepared for distributors, a psychological testing service provided, and many other types of service rendered. Evaluate this effort to achieve cooperative manufacturer-distributor relationships.

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[15] "Automation Gets It Wholesale," *Business Week*, March 15, 1958, pp. 157 ff.

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16. SPECIALIZED TYPES OF WHOLESALE MIDDLEMEN

There are many specialized wholesale middlemen operating in the various commodity markets. Although the dollar sales volume of some of them is relatively small, it is necessary that the marketing student be familiar with their particular functions and the nature of their operations. This chapter, therefore, will be concerned with three types of specialized wholesale middlemen: limited-function wholesalers, agent middlemen, and assemblers of farm products.

LIMITED-FUNCTION WHOLESALERS

Limited-function wholesalers are merchant middlemen who usually perform fewer marketing functions than do regular wholesalers, although in some instances they merely perform the functions in a different way. Among these special types of middlemen are drop shippers, wagon or truck distributors, cash-and-carry wholesalers, retailer-cooperative warehouses, and voluntary group wholesalers. The latter two have already been discussed in Chapter 12 in connection with the treatment of contract chains and need not be considered further. The first three will be discussed at this point.

Drop Shippers

Drop shippers, also called "direct-mill shippers" and "desk jobbers," operate in both the consumer goods and the industrial goods markets. They secure orders from retailers or industrial users and send them to the manufacturers, who then make the shipments directly to the retailer or user. Although they take title to, and thus buy and sell, the goods they market, they do not carry stocks and so have no warehouse or delivery expense and no in-

freight or out-freight charges. Credit is sometimes extended, but they commonly sell to good credit risks who buy in large quantities. They offer, consequently, a low-cost service which often enables them to charge lower prices and sometimes to make more rapid delivery than the regular wholesalers, who may make no effort to offer direct shipment service on large orders at the low prices which are often warranted.

Many wholesalers do some business on this basis, but they are not classified as drop shippers unless the majority of their sales are made in this way. It is a type of operation which is particularly important in the sale of bulky products in the marketing of which transportation costs run high. Drop shippers are especially significant in the marketing of coal and lumber. They are also used for farm supplies, machinery and equipment, paper products, and petroleum products. Drop shippers were not recorded separately in the census reports of 1954 and 1958. In 1948 there were 1,615 drop shippers with sales of $2,600,000,000. Operating expenses in 1948 averaged 4.5 per cent of sales.[1]

Wagon Distributors

The term "wagon distributor" or "truck distributor" is applied to the wholesaler who sells goods to retailers directly from his truck. Such wholesalers commonly carry a small line of fast-moving merchandise and often sell for cash. In 1958 there were 7,351 wagon distributors enumerated by the Census with a total sales volume of $1,536,722,000 (see Table 13-6 on p. 274). Most of these distributors were operating in three product lines: groceries and confectionery items, beer, and petroleum products.

Wagon distributors handle only a few related product lines and individual orders are small, usually ranging between $10 and $15 in the case of grocery distributors. However, as many as 40 or 50 calls can be made in a day. In the food field, wagon distributors concentrate on perishable items and specialties, including gourmet foods and imported items. They deliver new merchandise to the store and sometimes collect unsold products. This keeps the retailer's stocks complete and fresh at all times. Frequent calls make it unnecessary for the retailer to carry a large stock of the merchandise purchased in this way.

Since the wagon distributor concentrates on fast-moving items and becomes familiar with the requirements of his customers, he is likely to achieve a relatively high rate of stock turnover and thereby to eliminate some of the risks incurred by regular wholesalers. If he sells for cash, credit expense is also eliminated. The wagon distributor, however, is not basically a low-cost

[1] *U.S. Census of Business: 1954*, Vol. III, *Wholesale Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 1–11.

wholesaler, and it will be noted that the average expense ratio of 14.7 per cent in 1958 (see Table 13-6) is above the average for service wholesalers. Primarily it is the special service of the wagon distributor that appeals to retailers. Manufacturers find that the small line carried by the wagon distributor enables him to push products as few general wholesalers can. On the other hand, because such distributors operate on a small scale, do not operate at all in many areas, and are often relatively unknown in the trade, a manufacturer incurs some difficulty as well as some risk in using them.

Rack Jobbers. A special type of wagon distributor that has developed mainly since World War II is known as the "rack jobber." This wholesaler furnishes the supermarket, or large food store, with its nonfood items—housewares, toilet articles, drug sundries, toys, and similar products. The rack jobber assumes the responsibility of keeping the allotted display racks filled with this type of merchandise. He makes frequent calls, usually once each week, replenishes the stock of merchandise, and collects for products sold since the last call. In 1958 there were 1,508 rack jobbers with sales of $637,152,000. That rack jobbers offer an extensive service to retailers is indicated by the very high expense ratio, 18.3 per cent of sales in 1958.

The use of the rack jobber permits the food store operator to handle many profitable nonfood items without diverting a great deal of management time and effort to the merchandising of these products. The rack jobber performs the buying and warehousing functions for the retailer and even marks the retail prices on the products before delivering them to the store. There is evidence that the smaller supermarket operations tend to use the services of rack jobbers to a greater extent than do the larger ones.[2] Many chain store systems which once utilized the services of the rack jobber now buy their nonfood items from regular sources of supply, thus increasing their gross margins. The same is true of contract chains. Thus there is some evidence that the rack jobber's services are especially valuable when nonfood products are first introduced into the retail store. After the retailer has gained experience with these items, he may decide to take over the operation himself. For certain highly specialized products, however, such as housewares, he may continue to utilize the rack jobber's services indefinitely.

Cash-and-Carry Wholesalers

Cash-and-carry wholesalers developed during the twenties and thirties primarily as a means of selling to small independent retailers at relatively low

[2] John D. Horn, "Merchandising Non-Food Items Through Supermarkets," *Journal of Marketing*, April 1954, p. 382.

prices and thus enabling them to compete more successfully with chain stores. In 1958 there were 1,860 such wholesalers with a sales volume of $580,667,000. Between 1948 and 1954, there was a tendency for cash-and-carry wholesalers to decline both in number of establishments and in sales volume,[3] a trend that was very definitely reversed between 1954 and 1958. The decrease during the earlier period was especially significant when compared with sales of general-line wholesalers, which increased substantially between 1948 and 1954. Much of this decline took place in the grocery field where cash-and-carry wholesalers had been particularly important. Presumably this change in cash-and-carry wholesaling was related to the decline of the small grocery retailer previously noted in Chapter 11. The sharp reversal of the trend between 1954 and 1958 is difficult to explain, since the relative importance of the small grocery retailer has continued to decline. According to trade information, however, there has been a revival in cash-and-carry wholesaling in the food field, in part to serve certain needs of the larger independents, such as fill-in orders, and in part as a renewed effort to serve the small independent.

Like the regular wholesaler, the cash-and-carry wholesaler buys merchandise from manufacturers for sale to retailers in small quantities. But he commonly stocks only fast-moving staple lines, extends no credit, and makes no free deliveries. He ordinarily employs no outside salesmen and furnishes little market information to buyers. Since he carries only fast-moving merchandise and does not perform the full wholesaling service, he can quote prices lower than those of full-service wholesalers. Many of these firms operate a chain of establishments, and others are operated as the cash-and-carry departments of regular wholesalers.

In the fields in which cash-and-carry wholesalers operate most extensively, competition on a price basis is exceptionally keen, and hence the reduced prices offered are of great importance. It should be pointed out, however, that these low prices vary in importance to individual retailers. To take advantage of them, a retailer must pay cash and provide his own delivery of the products from the warehouse. He may be unable to pay cash, and the time spent in going to and from the cash-and-carry warehouse plus the expense of operating his own truck may largely offset the savings from the lower price he pays.

Conclusions

Limited-function wholesalers have developed in those product lines for which their method of operation is especially suitable. It is evident from the

[3] In 1948 there 978 cash-and-carry wholesalers with a total volume of $354,537,000, whereas in 1954 there were 922 such wholesalers with sales of $278,574,000. See *U.S. Census of Business*: *1954*, Vol. III, *op.cit.*, pp. 1–4 and 1–11.

foregoing discussion that they are of minor importance in the total wholesaling picture. Even in the product lines in which they are concentrated, they do not generally constitute a major competitive threat to the regular wholesaler,[4] although drop shippers in both coal and lumber appear to be of greater importance as to number of establishments and sales volume than are the regular wholesalers of these products. Nevertheless, the operations of limited-function middlemen are worth noting since these types of wholesalers render specialized services to manufacturers, retailers, and industrial buyers.

AGENT MIDDLEMEN

Whereas the merchant middlemen that have been discussed to this point are characterized by the fact that they take title to the goods they market, agent middlemen are distinguished by the fact that they do *not* take title to goods. While those classified as agent middlemen by the Census do occasionally sell for their own account, and thus take title, the proportion of their total volume marketed in this way in 1954 was negligible—amounting only to 3.1 per cent. Agent middlemen, especially brokers, may represent either the buyer or the seller. In 1954, however, only 7.4 per cent of total volume represented transactions on behalf of buyers. The remaining 89.5 per cent of the volume of agent middlemen in 1954 involved transactions in which the middlemen acted as agents for sellers.[5]

Importance of Agent Middlemen

The importance of agent middlemen is indicated by the fact that in 1958 they operated 26,567 business establishments with total volume of $46,422,643,000. More than three fourths of these establishments with almost two thirds of the volume were involved in marketing manufactured products.[6] It is not possible to obtain a breakdown between those establishments handling industrial goods and those involved in consumer goods. However, the data in Table 16-1 do give an idea of the classes of customers to which agent middlemen sell. The data include sales of all agent middlemen, not just those concerned with manufactured products.

It is interesting to note in Table 16-1 that agent middlemen in recent years have made a larger proportion of their sales to industrial users and a

[4] Retailer-cooperative warehouses and voluntary group wholesalers, which have not been discussed in this section, constitute an exception to this statement, of course, since they are of considerable importance in the grocery field.

[5] *U.S. Census of Business: 1954*, Vol. III, *op.cit.*, p. 26.

[6] According to 1958 census data.

TABLE 16-1

Sales of Agent Middlemen by Class of Customers, United States, Selected Years (per cent of total sales)

	Sales			
Class of Customer	*1935*	*1939*	*1948*	*1954*
To Retailers	21.0	16.8	16.1	13.8
To Industrial, Commercial, and Similar Users	34.9	35.8	41.8	43.7
To Wholesale Organizations	39.4	40.6	36.5	37.1
To Consumers and Farmers	0.1	0.7	0.4	2.1
For Export	4.6	6.1	5.2	3.4

Source: U.S. Census of Business: 1954, Vol. III, *Wholesale Trade* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), p. 18.

smaller proportion to retailers. This same trend was noted in Chapter 13 (see Table 13-4) with respect to merchant wholesalers. The reason for these trends is not especially evident, but it may well be that more consumer goods have been marketed directly in recent years and that more industrial goods have been marketed through middlemen, both agent and merchant.

Of the various agent middlemen listed in Table 13-6 on page 274, we shall be concerned here with five principal types: auction companies, brokers, commission merchants, manufacturers' agents, and selling agents. Table 16-2 summarizes the pertinent information regarding these five types for 1958. It will be noted that commission merchants have the highest total volume of sales and auction companies the lowest. However, selling agents exceed the other four types in average sales per establishment. Manufacturers' agents obviously operate on a much smaller scale than do the others. The reasons for this will be evident at a later point in the chapter when the nature of the operations of these various types of agent middlemen are discussed. For the present, it should be held in mind, in interpreting the data in Table 16-2, that brokers are of considerable importance in the marketing of agricultural products and that commission merchants and auction companies operate mostly in the agricultural market and only to a minor extent in the manufactured goods market. Selling agents are normally associated primarily with manufactured goods, and manufacturers' agents by definition do not operate in the agricultural markets.

TABLE 16-2

Number of Establishments, Sales Volume, and Average Volume per Establishment for Selected Types of Agent Middlemen, United States, 1958

Type of Agent Middleman	*Number of Establishments*	*Sales Volume (in thousands of dollars)*	*Average Volume per Establishment (in thousands of dollars)*
Auction Companies	1,840	4,552,442	2,474
Brokers	4,359	9,994,245	2,293
Commission Merchants	6,972	11,795,915	1,692
Manufacturers' Agents	9,983	9,687,647	960
Selling Agents	2,069	6,876,877	3,324

Source: Adapted from Table 13-6. Average volumes computed by the writers.

Services of Agent Middlemen

Agent middlemen, as a class, are engaged in negotiations that bring about the transfer of the title to goods from sellers to buyers. Since their chief function is to assist in the purchase or sale of goods, they usually have a wide knowledge of the markets for the particular products they deal in, a knowledge which is often of great value to the principals for whom they act as agents, as well as to the buyers or sellers on the other side of the sales transaction. They sometimes assist with financing and sometimes own or arrange for the use of warehousing facilities. But since they do not take title to goods, they do not bear the ordinary risks of marketing, except as these may fall on them as a direct or indirect result of any financing or warehousing operations they may undertake. Their assistance with finance may take the form of financing the principals whose products they sell, of making collections, or of guaranteeing the accounts of the firms to which they sell. By granting credit when their principals cannot or will not, they may likewise render financial assistance to the purchasers who buy through them.

Although the financing and warehousing operations of agent middlemen are sometimes important, these are not usually major considerations with those who use their services. They are chiefly engaged in the work of buying and selling, not for their own account, but in assisting other parties to consummate sales. This is their most important service. Assistance with financing, in particular, is growing less and less important, because both sellers and buyers are coming to have a stronger financial standing and hence are able

more and more to dispense with this service. In fact, as manufacturers and merchant middlemen grow in size and resources, they are often able to dispense with all of the services of agents.

For his services the agent middleman usually receives a fee. This is commonly a percentage of the dollar value of the exchanges he negotiates, but it is sometimes a definite amount per unit of product. These fees are usually paid by the seller, although brokers who represent buyers are sometimes paid by the buyer, and purchasing agents and resident buyers are usually paid by their principals.[7] Some idea of the relationship of these fees to sales can be obtained from an examination of the last column of Table 13-6 on page 274.

Agent middlemen who deal in agricultural products may operate in either local markets or central markets. However, those operating in local markets who buy directly from growers are classified by the Census under "assemblers of farm products" rather than under "merchandise agents and brokers." Consequently, the discussion at this point will be confined to those agent middlemen who are located in the terminal markets and who represent the grower or country shipper in selling products in those markets. Their primary service arises from their knowledge of the markets and of buyers' needs and from the fact that they operate on a large enough scale to conduct their operations economically. They are specialists in performing the selling function, and they can generally perform it much more economically and effectively than can the distant grower or shipper.

In some instances, manufacturers also find the use of agent middlemen to be the best and most economical means of selling their products. There are many large and small companies making single products or narrow lines of products that could be sold directly to ultimate purchasers only at an excessive cost or that will not stand the expense of a sales force in territories in which sales are made in small volume, at a great distance from the factory, or in widely scattered markets. Managements of other firms either lack marketing experience or feel that they must devote all their energies to production problems; and some firms are too inadequately financed to undertake their own sales efforts. Under all such conditions a competent agent middleman offers the advantages of an established sales force, knowledge of markets, and technical knowledge of the lines handled. Moreover, because he often

[7] The distinction between very small agent middlemen who operate as one-man organizations and some salesmen working on a commission basis is not always clear. This is particularly true of small manufacturers' agents. The basic distinction, however, rests in the fact that the agent middleman is an independent businessman working for himself and operating his own business but selling his principal's products under such conditions as may be determined in his contract with the principal. The salesman, on the other hand, is recognized as an employee, all of whose work is subject to direction by his employer.

sells the products of several manufacturers he can frequently market goods at less expense than could the individual firms he represents.

It is evident that, insofar as the same functions are performed, these advantages are similar to the advantages of using merchant middlemen. But just as there are many manufacturers who cannot sell directly to retailers or to industrial users, and hence sell to regular wholesalers, so there are manufacturers who find it impossible or inadvisable to sell to the many wholesale merchants who handle products in the lines they produce. In such cases, they find it necessary to use agent middlemen to sell their products to wholesale merchants. Agent middlemen offer a further advantage that often causes manufacturers to use them in preference to wholesale merchants for selling to some classes of customers. This is the superior sales service which agent middlemen are often able to perform. This superior service can be offered bcause they handle the products of only a few manufacturers and thus are able to devote a considerable amount of time to the sale of each product they carry. Furthermore, since they specialize in a few lines, agent middlemen and their salesmen usually develop a high degree of technical competence which enables them not only to present the advantages of the products they sell with great effectiveness, but also to give competent technical advice to those to whom they sell.

Agent middlemen also serve buyers. Their knowledge of sources, prices, and supplies, as well as their technical knowledge, particularly in the case of those who handle industrial goods, is often of great value. Such information is particularly helpful to small firms that cannot afford the expense of close contacts with markets or the hiring of adequate technical assistance. Larger firms, as well, often find this service valuable in the purchase of products not used in large volume and in obtaining products to meet emergencies.

Major Types of Agent Middlemen

The operations of the various types of agent middlemen differ in certain respects, but there is sufficient similarity that distinctions must be carefully made. The situation is further confused by the fact that some agent middlemen designated as "brokers" in a particular trade actually function in a different capacity. In addition, many agent middlemen in practice engage in more than one type of dealing. The following discussion indicates the basic distinctions between the broker, the selling agent, the manufacturers' agent, the commission man, and the auction company.

The Broker. The main duty of the broker is to bring buyer and seller together. Representing either buyer or seller, although usually the seller, his only

function is to assist in the consummation of sales and purchases. Brokers usually specialize in one particular product line and know the markets, the producers, and the buyers thoroughly. This enables them to render valuable services to their principals in seeking buyers or sellers and to provide information on market conditions.

[redacted] have narrow powers of representation. Usually they merely make contacts with possible purchasers or sources of supply and can sell or buy only after confirmation of the transaction by the principal. Sometimes they are given opening prices for purposes of negotiation, but any deviation must be referred to the principal. In general, brokers usually deal in larger lots, perform fewer functions, and exercise fewer powers than do other types of agent middlemen. They seldom have a permanent relationship with their clients, each transaction representing a separate deal. Obviously, good service often leads to a considerable degree of continuity of relationship, but such continuity is seldom of a contractual nature.

Since the services of brokers are restricted, their expenses tend to be low which permits them to charge lower fees. In 1958 selling brokers received commissions amounting on the average to 2.4 per cent of sales. The corresponding figure for buying brokers was 1.9 per cent. Brokers are paid a flat rate per unit of sale or a commission on the dollar volume of sales. Although their fees are low, there may be considerable variation from one trade to another.

Brokers have an important place in the marketing of agricultural products, usually dealing only in carlot quantities. Large shippers of fresh fruits and vegetables frequently sell through brokers, thereby obtaining the services of a middleman with wide market contacts in several markets. This is of particular advantage in disposing of perishable commodities quickly and at good prices. Such large organizations as Sunkist Growers, Inc., for example, are represented by brokers in markets in which they do not have their own sales representatives. Brokers frequently operate in the grain trade between terminal elevators and exporters, and exporters may sell through brokers also. Sometimes brokers in the agricultural markets perform additional functions: collecting for the principal, advancing funds to shippers, providing for storage, and representing the principal when goods are damaged in transit and storage. In such cases, it is often difficult to distinguish the broker from a commission merchant.

In manufactured goods, brokers are of greatest importance in the food field, although many so-called "food brokers" really operate as selling agents or manufacturers' agents. However, canned foods, refined sugar, flour, and food specialties are often handled on a regular brokerage basis. Brokers are also

used to some extent in other product lines, including textiles and dry goods and lumber. Brokers, and other similar agent middlemen, are important in the distribution of canned foods because canneries are often small and are usually located in the producing areas, whereas the wholesalers and large retailers to whom the products are sold are far away in the centers of population. On the other hand, brokers are also used by large manufacturers, as in the case of refined sugar—a product that is sold generally through brokers, although again many of these brokers would be more properly classified in another category of agent middlemen.

The Selling Agent. Selling agents operate under contracts which continue over a considerable period of time, such as a season, a year, or longer, and which usually provide for the sale of the entire output of the mill or factory involved. The authority they exercise in marketing the products sold is much greater than that of the broker or the manufacturers' agent. They usually determine prices, terms, and conditions of sale without consulting their principals, as the broker usually must, and are much freer to operate according to their own judgment than is the manufacturers' agent. The average commission received by all selling agents reporting to the Census in 1958 amounted to 3.5 per cent of sales.

Selling agents historically have been of greatest importance in the textile industry, but they also operate more or less extensively in a number of other fields: coal, metals, lumber, grocery and food products, and even in house furnishings. In practice, their operations may be difficult to distinguish from those of the broker and manufacturers' agent, but the functions they perform are more extensive. In addition to their performance of the selling function for manufacturers, selling agents may assist in financing the manufacturers' operations. Historically this has been the situation especially in the textile trade, although most of the financing services of the selling agents have now been taken over by factors.[8] In the textile industry, selling agents have even gone so far as to furnish mills with designs and patterns.

Selling agents are most likely to operate in product lines in which there are many small producers. The use of selling agents makes it unnecessary for the manufacturer to organize a sales force of his own or to negotiate through a large number of brokers in the various consuming centers. If he needs financial assistance, the selling agent may prove to be the most satisfactory source for securing it.

The Manufacturers' Agent. The services performed by the manufacturers' agent are very similar to those performed by the selling agent. There are important differences, however, in the powers which are exercised. Whereas

[8] See the discussion in Chap. 22.

the selling agent usually sells the entire output of the line or lines he handles for a manufacturer and usually determines prices and terms of sale himself, the manufacturers' agent sells a part of the output of each manufacturer he represents, in a limited territory, and prices and terms of sale are determined by the manufacturer. Like the selling agent, the manufacturers' agent may assist the manufacturer with his financing problems and may suggest new products or changes in existing products. Selling agents sometimes market competing products for several manufacturers in order to obtain an adequate volume to meet the needs of large customers and to reduce selling costs, but manufacturers' agents usually confine their efforts to noncompeting products in a narrow line, or an assortment of related products, agreeing with their principals to sell no competing items.

Manufacturers' agents are of greatest importance in the marketing of industrial machinery, equipment, and supplies. They also operate somewhat extensively in dry goods and apparel and in the electrical trade. Other important industry groups for manufacturers' agents include plumbing and heating equipment and supplies, automotive equipment, metals, and furniture and house furnishings.[9] It is interesting to note that manufacturers' agents, unlike brokers and selling agents, tend to be concentrated to a considerable extent in "hard goods" lines and that they are more likely to be used to assist in the marketing of industrial goods than are the other two types of agent middlemen.

Some manufacturers' agents perform the stocking function whereas others do not. In 1954 approximately one fourth of the manufacturers' agents enumerated by the Census carried stocks and performed the warehousing function. For most manufacturers' agents, however, the orders obtained were shipped directly from the manufacturer to the buyer. Commissions of agents not carrying stocks amounted to 5.3 per cent of sales in 1954 compared with 6.9 per cent for those with stocks. In 1958 the average commission rate for all manufacturers' agents was 5.9 per cent, the highest average rate obtained by any type of agent middleman. One of the reasons for this probably is the relatively small scale of operation of manufacturers' agents, which was noted previously in this chapter.

As was indicated above, sales of machinery and equipment made up the largest volume of business carried on by this class of agent middlemen. When operating in this field, manufacturers' agents usually sell a number of products, and may operate locally or over a considerable territory. They have sales organizations, occasionally stock goods, but seldom guarantee credits or

[9] Thomas A. Staudt, *The Manufacturers' Agent as a Marketing Institution* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1952), pp. 30–3.

finance their principals. As with other types of agent middlemen, because of their detailed knowledge of markets and their wide acquaintance with buyers and because of the fact that their expenses are spread over a number of lines, they are frequently able to offer a skilled sales force, and one which may be able to give valuable technical assistance to buyers, for a charge which may be much less than the expense for which these services could be supplied by the manufacturers' own marketing organizations.

The Commission Man. Commission men, or commission "merchants" as they are called by the Census, are one of the more important types of agent middlemen, but most of them operate in the marketing of agricultural products rather than in manufactured goods. Their methods of operation in the latter area fall someplace between those of the broker and the selling agent. Their powers are broader than those of the broker or the manufacturers' agent, and their relations with their principals are less continuous than those of the selling agent. Perhaps the chief distinction between the commission man and the selling agent is that the former does not sell the manufacturer's entire output. In manufactured goods, commission men are of importance primarily in the sale of dry goods.

In agricultural products, commission men are important in the sale of grain, livestock, and fresh fruits and vegetables. They are called "factors" in the cotton trade and merely "buyers" in some other trades. It is sometimes difficult to distinguish their operations from those of brokers, but they tend to perform more functions and to exercise more authority than do brokers. Commission men have complete power to sell the products consigned to them without consulting the principal with regard to price and other terms of sale. They may also take possession of the products they sell, unlike the broker, and do whatever is necessary to condition and prepare those products for market. They collect the proceeds of the sale for the client, deduct any costs that may have been incurred on behalf of the client—such as feed costs, freight charges, insurance, or inspection fees—, deduct their commission charges, and remit the proceeds to the principal. Like the broker, the commission man's primary service to the grower or country shipper lies in his knowledge of markets and in his ability to sell the products entrusted to him at satisfactory prices.

The Auction Company. Auction selling has not generally been associated with the organized marketing of manufactured goods. It is estimated, however, that since World War II more than 150 used car auctions have been established in the United States with an annual sales volume of one billion dollars.[10] Only automobile dealers can buy and sell at these auctions, which

10 "Where Car Dealers Buy and Sell," *Business Week*, March 14, 1959, pp. 130 ff.

provide a convenient means of bringing together dealers with an excessive number of used cars and those who need to replenish stocks. Auctions are held weekly at various locations throughout the country and are reported to be replacing the regular wholesaler of used cars. Generally speaking, auction selling is supposed to be most adaptable to the marketing of perishable products, since it provides an immediate market and reduces the risk of deterioration. With respect to used cars, the auction market appears to be providing a superior method of equalizing demand and supply. Not only can sellers and buyers make contact with one another more easily, but the prices established at auctions serve as a guide to all dealers in pricing used cars and to some extent new cars also.

A more traditional type of auction selling takes place in the wholesale distribution of fresh fruits and vegetables in certain central markets.[11] The auction company furnishes a place and a business mechanism whereby perishable products shipped in large quantities can be sold quickly. The company supplies a building to which the goods are taken and in which samples can be displayed. A daily catalog is printed listing the goods offered for sale on that day, and auctioneers are provided. Sales are made on the basis of samples representing each lot of goods.[12] After the sales are made, the company collects the proceeds, deducts its charges and commission for selling, and remits the balance to the owner of the goods or his representative.

The auctions are usually owned by middlemen, particularly receivers, but some are owned by persons outside the trade. They operate in the channel of distribution between the wholesale receivers of carlot shipments, or the brokers, commission men, or shippers' representatives who represent large shippers, and the wholesalers or retail stores that normally buy in less-than-carlot quantities. Goods sold in the auction are usually consigned directly to shippers' representatives, who turn them over to the auction for sale.

The auction represents the shipper and sells for him, or for the wholesale receivers and commission men who handle his produce in the central market. Buyers or their direct representatives attend the auction and bid on the goods as they are offered for sale. Jobbers buy the majority of products sold. Other important classes of buyers are the wholesale departments of chain store systems, buying brokers, truck jobbers, and retailers. Buying brokers represent middlemen who do not go to the auctions themselves, including

[11] Auctions are also used in the sale of agricultural products in local markets. Local market auctions are discussed in the section on "assemblers of farm products."

[12] These are not legally samples, since the auction company does not guarantee the lot to be like the sample. But they must be reasonably true samples if confidence is to be held and the best results obtained. Buyers are usually accorded the privilege of opening other packages than those containing the official samples.

some jobbers and chain stores as well as such small volume buyers as independent retail stores, hotels, hucksters, or pushcart vendors.

Declining Use of Agent Middlemen in Agricultural Marketing

The movement toward decentralization in the marketing of agricultural products, discussed in Chapter 4, has resulted in a decline in the use of commission men, brokers, and central market auctions. The function of all of these agent middlemen is to sell agricultural products in the central market. To the extent that central markets are bypassed, there are fewer products to be sold by middlemen operating in them. Examples may be found in both livestock and grain. The livestock commission company is still the typical agency handling livestock in the terminal public markets, but as we have seen previously a smaller percentage of livestock is being sold each year through these markets. The cash grain commission merchant similarly is the principal representative of the country grain elevator in the terminal markets, but the trend toward direct marketing has reduced somewhat the volume of grain entering the terminal markets.

With respect to fresh fruits and vegetables, direct purchase by the chains and other large buyers has had a similar effect. The use of commission men has declined substantially although brokers are still of considerable importance, as are auctions in some markets. Nevertheless, there has been a decline in the importance of the terminal auction and in the amount of consignment selling generally in terminal markets.[13] A contributing factor here has been the inadequate facilities and resulting congestion found in many of the wholesale terminal markets. This has encouraged buyers and sellers to bypass the central market if possible. In those cities, such as Chicago, Cleveland, Buffalo, and St. Louis, which have modern well-organized marketing facilities, a greater proportion of the products tend to pass through the terminal wholesale markets than is the case in those cities which have congested facilities.[14]

[13] See Alden C. Manchester, *Changing Role of the Fruit Auctions*, Marketing Research Report No. 331 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, June 1959).

[14] See J. Stanford Larson, *Wholesale Produce Markets*, Marketing Research Report No. 91 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, April 1955), pp. 3, 8. Conditions in Philadelphia have been vastly improved with the opening of the new Food Distribution Center in 1959 to replace the old Dock Street market. See "Behold the Grocers' Supermarket," *Business Review*, Federal Reserve Bank of Philadelphia, June 1960, pp. 3–10. Market facilities in New York are still very congested. See Harry G. Clowes, *New York City Wholesale Fresh Fruit and Vegetable Markets*, Marketing Research Report No. 389 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, June 1960).

ASSEMBLERS OF FARM PRODUCTS

Assemblers of farm products consist primarily of the merchant middlemen operating in the local agricultural markets, although the Census also includes in this category those agent middlemen in local markets who deal directly with growers.[15] Local market middlemen assemble farm products from growers and sell them to central market wholesalers, chain store buyers, processors, mills, and factories.

In 1929 there were 30,916 assemblers of farm products whose sales constituted 6.2 per cent of the total wholesale sales volume of the nation. Since that time (see Tables 13-2 and 13-3 on pages 268 and 270), there has been an almost constant decline both in number of establishments and in relative sales. In 1958 there were only 14,096 establishments doing business as assemblers, and the sales volume of $8,998,640,000 represented a mere 3.1 per cent of all wholesale sales. There are probably several reasons for this decline in the importance of local market assemblers, but the most important is the trend mentioned previously toward more direct buying and selling. This has affected local market middlemen as well as the central market middlemen handling agricultural products.

There are many different types of farm products assemblers operating under various designations. For convenience in discussion, they may be classified as follows: (1) private resident buyers, (2) traveling buyers, (3) order buyers, (4) merchant truckers, (5) local auctions, and (6) local cooperative associations.

Private Resident Buyers

Resident middlemen with an established place of business to which growers haul their products are the most important class of local buyers. They are sometimes independent local dealers and sometimes local representatives of outside dealers and manufacturers.

The country grain elevator is the best known example. The bulk of all the grain which finally reaches the central markets and the processing mills of the country is first hauled by growers to local grain elevators.[16] There it is

[15] The present discussion will also refer to some agent middlemen in the local market who do not necessarily deal directly with growers and who presumably have been classified by the Census under "merchandise agents and brokers."

[16] Approximately 36 per cent of the local elevators are owned and operated by local businessmen. Some 26 per cent are owned cooperatively by the farmers themselves and are not private resident buyers, of course, as the term is used here. The remaining 38 per cent are local units in a "line" elevator system controlled from a headquarters which is usually

weighed and graded as it is received, and cash is usually paid on delivery. The price is normally based on the grade of grain delivered, and the grower is paid the current price for that grade at the central markets of the area, minus freight and elevator charges. In the normal elevator operation, the purchased grain is held until judgment or lack of storage space dictates shipment to the central market.

Private resident buyers are also prevalent in most other lines of agricultural products. Throughout the fruit and vegetable producing regions, growers sell to local packer-shippers and warehousemen, who buy and store the products and often sort and grade them. They also store for the grower and sell for him on commission. About 15 per cent of livestock sales are made to local buyers who forward their purchases to interior buyers, to local packers, and to commission men at central livestock markets.[17] Some of these buyers have arrangements under which they sell some or all of the stock they purchase to particular meat packers. Wool and cotton, likewise, are often sold to local buyers. The bulk of the cotton, for example, is sold to four types of local buyers: independent local buyers, cotton gins, cooperative associations, and representatives of cotton merchants. The first two, which are properly classified as private resident buyers, are the most important.[18] Even in tobacco, which is sold almost entirely through local auctions, growers in certain areas may choose to sell to "transfer buyers" rather than directly at the auction. Transfer buyers prepare the product for market and resell, utilizing the services of the auction, to packer-buyers, warehousemen, and speculators.[19]

located in a central market and owned by a large grain dealer. A few of the "line" elevators are the property of millers. U.S. *Census of Business: 1954*, Vol. III, *op.cit.*, p. 9–19.

[17] In 1955 farmers in the United States sold their livestock as follows:

Through terminal public markets	34.2 per cent
Through local auctions	25.7
Direct to packers	14.7
To local dealers	15.1
To other farmers	8.2
Other	2.1

See Victor B. Phillips and Gerald Engelman, *Market Outlets for Livestock Producers*, Marketing Research Report No. 216 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, March 1958), p. 11.

[18] During the 1947–48 season, cotton growers in the United States sold 36 per cent of their output to independent local buyers, 33 per cent to ginner-buyers, 6 per cent through cooperatives, and 11 per cent to representatives of cotton merchants. Twelve per cent was sold through factors or brokers. *Marketing of Cotton in Producers' Local Markets* (Washington, D.C.: Production and Marketing Administration, U.S. Department of Agriculture, September 1949), p. 25.

[19] C. I. Hendrickson and F. H. Dahl, *Resales at Maryland Tobacco Auctions*, Marketing Research Report No. 148 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agrioulture, December 1956), p. 4.

As these local dealers usually pay the grower cash for his products,[20] they need rather large supplies of capital during the season when shipments are heavy. Furthermore, the products are frequently consigned by the dealer to central market commission men or sold subject to grading at the central market. Consequently, but for the financial arrangements made with his customers in the central market and with the local banks, the local buyer would need to possess a large amount of capital. But it has become common practice to draw on the central market dealer for a large percentage of each shipment, the balance being sent on to the local middleman after the sale is complete. This shifts a large part of the burden of financing purchases at local markets from the local shipper to middlemen in the central markets.

Traveling Buyers

Fruits and vegetables, poultry, eggs, wool, cotton, rice, livestock, and grain are sometimes sold to traveling buyers who either travel from farm to farm or station themselves at a local shipping point to meet the growers as they bring their products to town. Some of these buyers are independent dealers; others are the representatives of central market dealers or of manufacturers and processors. Many of them make their appearance during the season when products are maturing, and then move on to another section. Others are resident middlemen in the local market who carry their buying efforts to the farm.

Traveling buyers representing cotton merchants, export houses, brokers, and mills purchase in large volume from resident buyers, but they also purchase directly from growers at local markets and at the farm. In some areas local buyers haul livestock, particularly hogs, to concentration yards and buying stations for shipment and sale to packer-buyers. A considerable volume of cigar-leaf tobacco is sold to traveling buyers, sometimes in advance of the harvest. The greatest use of traveling buyers is probably found, however, in fruits and vegetables. Canners often send representatives into the producing areas, as do chain stores, central market dealers, and others, to contract for supplies directly with the grower or with resident buyers.

Order Buyers. An order buyer is a specialized type of traveling or resident buyer of sufficient importance to warrant special mention. Order buyers function essentially as shipping point brokers representing central market produce wholesalers, cotton mills, meat packers, grain dealers, and other

[20] For this reason, the term "cash buyer" is often applied to resident buyers, and sometimes to traveling buyers, to distinguish them from buyers who merely handle the product on a commission basis for the grower's account. Many resident buyers give the grower the choice of selling to them outright for cash or of consigning the product to them on a commission basis.

processors and distributors. They buy a specific kind and grade of product on order of the principal. Thus they function generally as agent middlemen. Except in the case of potatoes and occasionally certain other fruits and vegetables, they do not buy directly from the grower but purchase from resident buyers.[21]

Merchant Truckers. Another specialized type of traveling buyer is the merchant trucker, who has attained a considerable degree of importance in recent years as a result of the increasing use of motor truck transportation. Merchant truckers purchase fruits and vegetables, eggs, and livestock either at the farm or at shipping point markets, then transport and sell them directly to processors, to wholesale merchants, and to retailers. There is a tendency for the merchant trucker to become more important during periods of depression when regular employment is hard to obtain, but this type of buyer is now well established as a permanent factor in the agricultural marketing system.

Local Auctions

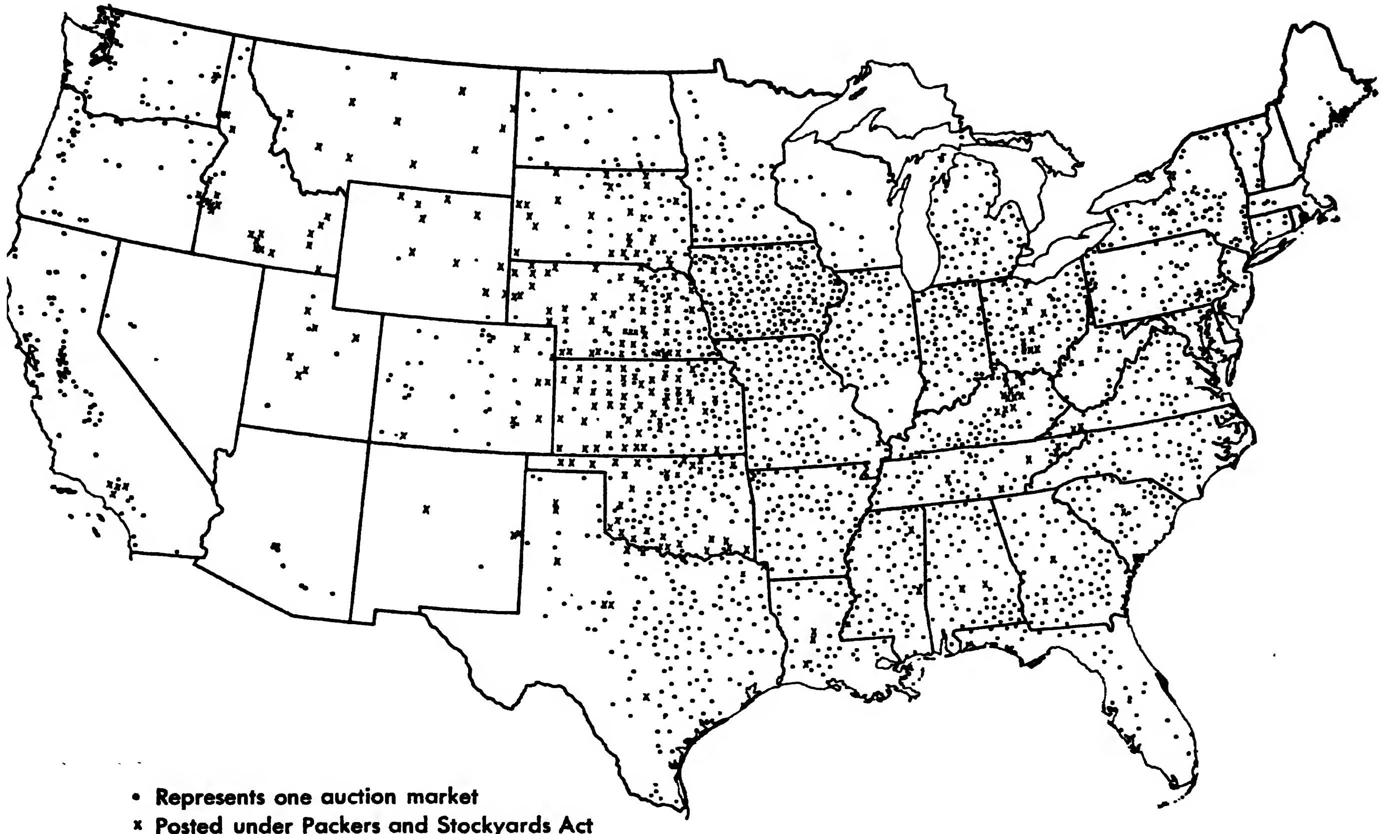
Local auctions at which the farmer's products are sold have existed for many years. Loose-leaf tobacco auctions handle over 90 per cent of the tobacco produced in the United States, virtually the entire crop except for cigar-leaf types.[22] Livestock auctions have grown tremendously in importance, especially during the period between 1930 and 1950, and now handle over 25 per cent of all livestock sold by farmers.[23] Figure 16-1 shows the location of the more than 2,300 livestock auction markets existing in 1955. Other products sometimes sold at local auctions include eggs and certain fruits and vegetables.[24] Some auctions are cooperative ventures controlled by the growers; others are privately owned. The tobacco and livestock auctions are largely private ventures. All auctions, regardless of their sponsorship, act as agent

[21] *Marketing: The Yearbook of Agriculture, 1954* (Washington, D.C.: U.S. Department of Agriculture, 1954), p. 29.

[22] Clarence I. Hendrickson, *The Auction Marketing of Flue-Cured Tobacco*, Marketing Research Report No. 101 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, September 1955), p. 3.

[23] As noted in footnote 17 supra. The importance of local auctions varies considerably according to the product and the region. They are relatively more important in the marketing of cattle and calves than they are for hogs and sheep. Over half of the livestock in the South is sold through auctions compared with approximately one sixth in the North Central and Western states. Victor B. Phillips and Gerald Engelman, *op.cit.*, pp. 11 and 14.

[24] There appear to be somewhat fewer than 100 local auction markets for fruits and vegetables, located mainly along the South Atlantic seaboard. Although a relatively small proportion of fruits and vegetables are sold through local auctions, in some areas and for some products they are of considerable importance. See Roger F. Burdette, Imogene Bright, and Charles K. Baker, *Farmers' Produce Markets in the United States*, Part III, *Shipping Point Fruit and Vegetable Markets*, Marketing Research Report No. 17 (Washington, D.C.: U.S. Department of Agriculture, May 1952), pp. 5–14.



Source: U.S. Department of Agriculture, Neg. 1916-55 (10).

Figure 16-1. Location of 2,322 U.S. Livestock Auction Markets, 1955 (including 255 posted markets).

middlemen, merely providing a mechanism by which buyers and sellers are brought together in one place.

As a rule, auctions are held on certain days of the week and at specified hours. Farmers and local buyers truck their products to the auction, where they are sold by the auction company to local middlemen and particularly to middlemen from outside areas and to manufacturers' representatives. The auction company often collects from the buyer and pays cash to the grower.

It is difficult to generalize concerning the effectiveness of this method of sale. It offers a place at which sales can be made to buyers who are bidding competitively, and for buyers it saves time that is otherwise spent in calling on farmers or dealing with them individually at a local place of business. Moreover, local auctions frequently grade products or exercise a favorable influence on grower grading. But sometimes the number of buyers present is so small that satisfactory prices fail to develop, buyers are occasionally accused of agreeing on prices before selling starts, and, in the case of livestock auctions, facilities for weighing and caring for the livestock and for the prevention of the spread of disease are sometimes inadequate.

Local Cooperative Associations

Grower-controlled cooperative shipping associations have become an important outlet for the products of many sections of the country. Grain, fruit, vegetables, dairy products, livestock, tobacco, cotton, wool, and many other products are now sold in large volume through these associations. They are a natural development in an industry which tends to operate on a small scale. The individual grower operating a family-sized farm is able to cope with the problems of production with considerable success. But effective marketing often requires large-scale operations and an entirely different type of skill, and it is much more effectively carried on by group action or by independent middlemen.

The actual operations of local cooperative associations commonly parallel those of the local middlemen who handle the same products, but the ownership and some of the objectives are different. Because of these differences and because of their importance, cooperatives will be discussed in more detail in the following chapter.

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See also the general references at the end of Chapters 4 and 14.

17. COOPERATIVE MARKETING OF AGRICULTURAL PRODUCTS

Farmer cooperative marketing associations are of interest because they perform an important share of the marketing of many agricultural products and because their distinctive forms of organization and operation, methods of control, point of view and attitude toward organization profits set them apart from all other business organizations found in the marketing of farm products. Agricultural cooperation has also on occasion been the agent of efforts by government to aid farmers.

THE FARM COOPERATIVE MOVEMENT

Growth and Extent of Agricultural Cooperation

In the 1957–58 marketing season there were over 6,000 marketing cooperatives with almost four million farmer memberships handling agricultural products valued at more than $10 billion. These products included practically every type of commodity grown on American farms and ranches. The 1957–58 figures for the nine most important commodities and for miscellaneous associations are shown in Table 17-1. From this table it will be seen that dairy products, with an estimated business of almost $3.5 billion, head the list, grain ranks second with over $2.6 billion, while livestock is third with more than $1.4 billion, and fruits and vegetables fourth with $1.1 billion.

It is interesting that the number of marketing associations, as shown in Table 17-2, has shown a steady decline since 1929–30, while membership remained stable through 1941–42, gradually increased through 1951–52, and since that time has shown little trend, although declining somewhat the last two or three years. This reflects a tendency both toward growth of individual

TABLE 17-1

Number, Estimated Membership, and Estimated Gross Business of Farmer Marketing and Purchasing Cooperatives by Specified Commodity Groups, 1957–58 [a]

Commodity	Cooperatives Listed [b]		Estimated Memberships [c]		Estimated Gross Business [d]	
	Number	Per Cent	Number	Per Cent	Amount (in thousands of dollars)	Per Cent
Beans and Peas (dry edible)	15	0.3	7,030	0.2	34,698	0.3
Cotton and Cotton Products	563	9.2	438,375	11.3	460,815	4.4
Dairy Products	1,606	26.3	728,815	18.8	3,490,673	33.2
Fruits and Vegetables	730	12.0	126,370	3.3	1,169,344	11.1
Grain, Soybeans, Soybean Meal and Oil	2,107	34.5	987,065	25.4	2,621,725	25.1
Livestock and Livestock Products	490	8.0	880,255	22.7	1,433,994	13.7
Nuts	36	0.6	56,135	1.4	126,088	1.2
Poultry Products	142	2.3	108,885	2.8	416,348	4.0
Rice	59	1.0	12,530	0.3	167,142	1.6
Sugar Products	66	1.1	34,430	0.9	349,688	3.3
Tobacco	36	0.6	367,460	9.5	145,161	1.4
Wool and Mohair	185	3.0	112,335	2.9	23,862	0.2
Miscellaneous	67	1.1	18,755	0.5	52,391	0.5
Total Marketing	6,102	100.0	3,878,440	100.0	10,491,929	100.0
Farm Supply	3,381		3,543,055		3,267,146	
Farm Service	233		63,595		246,641	
	9,716		7,485,090		14,005,716	

[a] Preliminary.

[b] Includes independent local cooperatives, federations, and centralized cooperatives.

[c] Includes members (those entitled to vote for directors) but does not include nonvoting patrons. There is some duplication in these membership figures because many farmers belong to more than one cooperative.

[d] Includes some duplication from intercooperative business.

Source: Anne L. Gessner, *Statistics of Farmer Cooperatives, 1957–58,* General Report 76 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, June 1960), Tables 1, 3, 4, 9, and 10.

cooperatives and also toward consolidation into larger cooperatives. At the same time, until the fifties changes in dollar volume of products marketed seem to have largely followed changes in the prices of agricultural commodities. It will be seen that sales declined from the twenties to the mid-thirties, rose through 1937–38, fell again, rose continuously with wartime and postwar

inflation, and reached new highs during the fifties. There is no conclusive evidence available to indicate how much of the dollar rise since the twenties in goods marketed represents a relative rise (or fall) in the proportion of goods handled by farmer cooperatives and how much simply reflects rising prices. Simple comparison of the total value of all farm marketings compared with the total value of business of farmers' marketing cooperatives during this

TABLE 17-2

Farmer Marketing Associations:[a] Number of Associations, Estimated Membership, and Estimated Business, for Specified Periods 1913 to 1957–58

Period [b]	*Number of Associations*	*Estimated Membership* [c]	*Estimated Business* [d] *(in thousands of dollars)*
1913	2,988	—	304,385
1915	5,149	591,683	624,161
1921	6,476	—	1,198,493
1925–26	9,586	2,453,000	2,265,000
1927–28	10,195	2,602,000	2,172,000
1929–30	10,546	2,630,000	2,310,000
1930–31	10,362	2,608,000	2,185,000
1931–32	10,255	2,667,000	1,744,000
1932–33	9,352	2,457,300	1,199,500
1933–34	9,052	2,464,000	1,213,000
1934–35	8,794	2,490,000	1,343,000
1935–36	8,388	2,710,000	1,586,000
1936–37	8,142	2,414,000	1,882,600
1937–38	8,300	2,500,000	2,050,000
1938–39	8,100	2,410,000	1,765,000
1939–40	8,051	2,300,000	1,729,000
1940–41	7,943	2,420,000	1,911,000
1941–42	7,824	2,430,000	2,360,000
1942–43	7,708	2,580,000	3,180,000
1943–44	7,522	2,730,000	4,430,000
1944–45	7,400	2,895,000	4,835,000
1945–46	7,378	3,150,000	5,147,000
1946–47	7,268	3,378,000	6,005,000
1947–48	7,159	3,630,000	7,195,000
1948–49	6,993	3,973,000	7,700,000
1949–50	6,922	4,075,000	7,082,600
1950–51	6,507	4,117,410	7,982,609
1951–52	6,582	4,228,560	9,257,072
1952–53	6,489	4,246,580	9,292,141
1953–54	6,445	4,272,900	9,195,512

(Continued on next page)

TABLE 17-2 (*Continued*)

Period [b]	*Number of Associations*	*Estimated Membership* [c]	*Estimated Business* [d] *(in thousands of dollars)*
1954–55	6,316	4,212,890	9,340,774
1955–56	6,268	4,222,365	9,505,945
1956–57	6,267	4,120,515	10,098,854
1957–58	6,102 [e]	3,878,440 [e]	10,491,929 [e]

[a] Includes independent local associations, federations, centralized associations, and sales agencies.

[b] Data for years prior to 1950–51 are not entirely comparable as the result of revisions made in statistical procedures in 1950–51.

[c] The membership estimates for the years since about 1935 include members, contract members, and shareholders, but do not include patrons not in these categories. Some duplication occurs since some farmers belong to more than one association. Membership figures are greatly affected each year by the comparative importance of cooperatives in price stabilization programs. They are also affected by the number of members reported who may not be active patrons in a specific year.

[d] Includes the value of commodities sold or purchased for patrons and the service charges for associations rendering other essential services either in marketing or purchasing.

[e] Preliminary.

Source: Anne L. Gessner, *Statistics of Farmer Cooperatives, 1957–58, op.cit.*, Tables 1 and 3 and Appendix Tables 5, 6, and 7.

period would indicate, however, that there has been a gradual increase in the relative share of goods handled by farmer cooperatives.

Objectives of Farmer Cooperatives

It is evident that farmer cooperative associations have attained a position of considerable importance in the marketing of agricultural products. The overriding objective in the expansion of the cooperative movement among farmers has been to increase the income of the farmer members as much as possible. This has involved efforts by the cooperatives both to obtain higher prices for the products sold by their members, and to lower their costs of production and marketing. Among the approaches to bringing higher prices for their members have been the development of orderly marketing, better selling methods, improved quality and better grading, the elimination of trade abuses, increased bargaining powers, and price fixing. Among the methods used in attempting to lower costs have been improved marketing methods, and lowered costs of production on the farm.

Characteristics of Farmer Cooperatives

Farmer cooperatives differ in purpose from the ordinary corporate enterprise in that their objective is to help maximize the income of their members as patrons of the association, rather than to maximize the income of the firm as such. To assist in achieving this objective their organizational structure is distinguished from that of the regular corporation in several important characteristics. Thus most cooperatives limit voting strength to one vote per member, regardless of how many shares of stock any individual member may own.[1] Dividends on stock are limited to a fixed amount per share regardless of how large the profits of the association may be. Earnings above the limited rate on stock are then customarily divided among the members or patrons[2] in proportion to the amount of business done with the cooperative, not on the basis of the amount of stock owned or capital invested as is the case with the ordinary corporation.

These organizational features are clearly designed to assure that the control of the association and the benefits from its operation will not pass into the hands of a few large stockholders who might be interested in obtaining the highest profit from their investment rather than in maximizing the income of the patrons. The policies of one vote per member, limitation on the dividends on stock, and the distribution of earnings according to patronage, are all intended to keep control in the hands of the patrons and see to it that any benefits from the cooperative accrue to them as patrons, not as owners.

In most other respects cooperatives are similar in organization to standard corporations. An important difference, however, often exists in the methods used to finance the cooperative. Cooperatives may, and commonly do, use many of the same financial instruments for obtaining capital which are used by ordinary corporations including the issuance of common stock, preferred stock, and various types of debt instruments. However, because net margins remaining after payment of expenses and any dividends at the fixed rate on stock are distributed to patrons, cooperatives often find it difficult to raise capital by the sale of common stock. Therefore, they have developed what is called the revolving fund or revolving capital plan. Under this plan co-

[1] A substantial proportion of cooperatives are nonstock corporations in which membership is obtained by the purchase of a membership certificate.

[2] Many cooperatives place limitations on the distribution of patronage dividends to nonmember patrons.

operatives obtain their capital in large part from their own patrons by withholding from them a part of the funds due them each year and instead issuing to them some form of debt or equity instrument evidencing the amount retained. Then as the association obtains as much capital as it wishes by repeating this procedure each year, it becomes possible to retire the oldest withholdings out of funds currently withheld from patrons. Thus after the capital begins to "revolve," new evidences of the retention of funds will be issued for the current withholdings, while the oldest paper outstanding is retired.[3]

Types of Marketing Cooperatives

As cooperatives have developed they have spread to different parts of the country, and associations have been organized to sell an increasing number of products. A variety of conditions has called forth organizations in a variety of forms. These include local, federated, and centralized associations. Most of these associations are organized to perform a large part or all of the marketing services for their members, although some associations perform only a single function.

Local Associations. Local cooperative associations are composed of producers in a single community. These associations, constituting over 90 per cent of all farmer cooperatives, are voluntary organizations in which membership is obtained by buying a share of stock, paying a membership fee, or signing a marketing contract. They are frequently, although not always, limited to those who produce a particular commodity, and their activities are largely confined to local shipping points. The local elevator company with 50 to 100 members, the farmers' potato warehouse, the fruit packing house, the cheese factory with a dozen or two dozen members, and the creamery with its 100 to 300 members are illustrations of local associations.

Independent local cooperatives ordinarily have no close connection with each other. The services performed by a particular association depend upon the kind of commodity it handles, but they usually include assembling the product, grading and packing if necessary, providing for transportation, making market contacts, selling the products, and collecting and distributing the proceeds. Some of them, particularly in the dairy industry, are primarily engaged in processing the raw products or in bargaining with city distributors. The organizations are of varying complexity, and their permanence likewise

[3] See Helim H. Hulbert, Nelda Griffin, and Kelsey B. Gardner, *Revolving Fund Method of Financing Farmer Cooperatives*, General Report 41 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, March 1958).

varies. They may be organized simply for a season or they may be incorporated, own property, and carry on extensive sales efforts.

These local associations perform many valuable services. But there are some things which a local independent association cannot do, and some things which it cannot do well. It is practically impossible for a local to give its members a complete marketing service, including expert management, desirable contacts with the wholesale markets, complete market information, adequate warehousing facilities, and financing services. Its bargaining power is frequently too weak to cope effectively with the large private organizations with which it must deal. And it is ordinarily unable to establish and maintain proper grades and standards. There has been a trend over time, consequently, toward the organization of federated associations large enough to overcome the weak elements of the individual local association, as well as to undertake services it cannot perform.

Federated Associations. The federated type of cooperative is ordinarily formed by the voluntary association of a number of established locals, and it has only such powers as are delegated to it by the locals. The individual farmer members of the local associations usually have no direct connection or legal relationship with the central organization. Contracts are made between producers and locals, and between the locals and the federation. The locals ordinarily own and control their own physical facilities. Local activities, including the enforcement of contracts with members, assembling products, grading and packing, are commonly carried on independently by each local. Those services which the locals agree can be more effectively carried on for the group as a whole are turned over to the central organization. These may include selling the products, pricing, financing, collection of proceeds, establishing grades, joint purchasing of supplies, the handling of transportation claims, controlling the flow of products to markets, the utilization of by-products, carrying on research, keeping the locals informed of market conditions, and advertising.

The proportion of these services performed by the federation varies greatly among associations. An excellent example of a federated cooperative which performs a wide range of functions for the member cooperatives is Sunsweet Growers, Inc., formerly California Prune and Apricot Growers Association.[4] In recent years this association has marketed here and abroad over 40 per cent of the dried prunes, one third of the dried apricots, and 30 per cent of

[4] This description is based largely upon Harry C. Hensley, *Marketing Policies of the California Prune and Apricot Growers Association*, Circular C-132 (Washington, D.C.: Farm Credit Administration, U.S. Department of Agriculture, February 1948), brought up to date with information supplied by T. J. Miller, Secretary of Sunsweet, in a letter dated August 8, 1960.

the dried peaches produced in the United States. The association is composed of 25 local associations with some 5,000 grower members who own and control the federation through their local cooperatives. The association uses a revolving fund plan of financing under which each individual member annually contributes capital in proportion to the business done with the cooperative. After sufficient capital has been accumulated, each year the member's capital investment made in an earlier year is returned on approximately a seven-year revolving schedule.

This federation provides a wide assortment of services for member associations and their members including the preparation and distribution of crop estimates, recording of new plantings and abandoned acreages, provision of horticultural and orchard management specialists, provision of market and price information, harvest loans, and fire insurance. In particular, however, its success has been due in large measure to three things: the development of an effective processing and marketing organization, the stimulation of demand through improvements in packaging and the use of trade and consumer advertising, and the application of research which has led to higher quality and to over-all improvement in marketing and distribution.

Sunsweet Growers, Inc., has established uniform standards for its products and sees to it that uniform receiving, grading, classification, and inspection policies are carried out in all plants. All of the fruit of a given variety, size, and quality grade handled by the federation is pooled to spread risks and reduce marketing costs.[5] Packaging is done either in bulk fiber cases or in various consumer packages. Improved packaging to assure the delivery of a high quality product and processing improvements have been the two main phases of an aggressive research policy. The association uses broker-wholesaler-retailer channels and closely coordinates its sales and advertising policies. Particularly important and successful has been its advertising policy which has been designed to win increasing consumer preference for its brand, Sunsweet. These expenditures have averaged about 5 per cent of sales and run to several hundred thousand dollars a year.

Some federated associations perform even more services of various kinds, for example, Sunkist Growers, Inc., which, together with the local associations in the Sunkist system, reaches into many phases of citrus fruit production, preparation of fruit for market, marketing, developing and improving by-products, nutrition, and membership relations.[6] Other associations cover

[5] Pooling occurs when the output of a number of producers is joined together for marketing with payment on the basis of the average price received. Pooling is described later in this chapter.

[6] An interesting description of Sunkist is in Irwin W. Rust and Kelsey B. Gardner,

a considerably wider variety of products. For example the Land O'Lakes Creameries, Inc., operating in the North Central states has expanded from the production of creamery butter to a full line of dairy products including cheese, cream, powdered milk, buttermilk, eggs, and poultry products. On the other hand, some federations have concentrated their efforts largely on one product and on one phase of its marketing. For example the Union Equity Co-operative Exchange, operating in Oklahoma and Texas, has confined itself mainly to acting as a cooperative grain sales agency through which the farmers belonging to its 85 member cooperative elevator associations can market their grain. At Enid, Oklahoma, it has the largest elevator capacity in the world owned and operated by one company at one location. The association has a membership on the Chicago Board of Trade which it uses for its own account. As its main activity it actually buys and sells the grain of its patrons. It also operates a complete milling and baking laboratory for determining the milling and baking qualities of wheats so as to be in a position to meet the demands of the flour mills. Other well-known federated cooperatives are the Diamond Walnut Growers, Inc., and the Ocean Spray Cranberries, Inc.

Centralized Associations. The centralized cooperative marketing association, unlike the federated type, is built from the top down, that is, control rests in the central association. The individual producers are members of the central organization, and make their contracts directly with it. All the marketing functions, including those performed in local markets, are controlled from the top. Often there are no local units in a centralized association. More frequently informal groups are established in localities largely for the purpose of strengthening and maintaining a spirit of loyalty to the central association. They derive such powers as they have from the central organization and usually have at the most an advisory relationship with the central.

Centralized cooperatives are a later form of organization than federated cooperatives. Many of them were formed from 1920 to 1925 with the purpose of gaining power to fix prices through control over the supply. These efforts did not, however, meet with any success for more than short periods of time, and price fixing as a prime objective has been succeeded by the more sound attempt to control the marketing of a sufficient volume of production to provide proper marketing facilities and to assure an effective marketing program.

Centralized cooperatives have proved to be a form of organization well suited to the producers of such products as eggs and poultry, apples, and

Sunkist Growers, Inc.—A California Adventure in Agricultural Cooperation, FCS Circular 27 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, 1960).

cotton. Western Farmers Association operating in Washington, Oregon, and Idaho with 41 branches and through 15 distributors is a good example of this form of cooperative. The individual farmer's membership is directly in the central organization. To keep the marketing membership in close touch with the organization, the members are grouped into "producer councils" for the various types of products marketed. These are informal unincorporated organizations meeting two to four times a year to discuss marketing and production problems. They provide two-way communication since the councils may make recommendations to the Association, while at the same time the central management may meet and discuss the affairs of the Association with the local members. The Association owns its own processing plants for eggs, poultry, turkeys, field seeds, and dry edible beans, as well as its own feed mills and branch service stores.

Much emphasis is placed on strict quality standards of production by its member producers, and the Association likewise exercises every possible means of conserving the quality of the products in its processing and marketing. This means better acceptance of the products by consumers and hence better returns to producers. Products are marketed on a pool basis by grade of quality, the length of the pools varying by products. For example, pools on eggs are settled each week as production by each member is fairly uniform from week to week and eggs are all sold currently with no storage. Fryers are marketed in quarter-year pools as producers generally market one flock of birds each quarter. Any net margins at the close of the year, after provision for reserves, are returned to producers on a patronage basis. The Association has been very successful in developing preferred markets for its products.

Prior to World War II a substantial portion of its products were marketed on the Eastern seaboard. Since that time population increases in the Pacific Northwest and Alaska have absorbed all its production of eggs, fryers, and most turkeys. Canned poultry and turkey, as well as seed and dry edible beans are still sold in other areas of the United States and in off-shore points. The Association has been very successful and is now one of the largest farmer cooperatives in the United States in volume of products marketed and purchased for its members.

Apple growers have also found the centralized cooperative a convenient form of organization. Typical of these is the Blue Ribbon Growers, Inc., of Yakima, Washington. The association operates its own packing and storage facilities and does its own selling on central markets, emphasizing in particular its own Blue Ribbon brand of top-grade fruit. All apples, as well as other fruits handled, are pooled according to size, grade, and variety, with

payment to members being made gradually through the season as sales are made.

The centralized cooperative is also the typical form for large-scale cotton marketing cooperatives in the South. Most of these were formed in the years after 1920 with the expectation that by gaining control over a sufficient percentage of the crop, they would dictate cotton prices. These expectations were disappointed in the midst of many failures and reorganizations. Experience indicated, however, that these large associations could perform many valuable services, such as grading, warehousing, assembling, insuring, financing, hedging, selling, and shipping. Thus the emphasis has shifted to the problem of extending and improving marketing services to members at minimum cost. Some of these associations cover a state or part of a state as does the Staple Cotton Cooperative Association in Mississippi, while others operate in several states as does the Cotton Producers Association operating in Georgia, Alabama, and South Carolina.

Cooperative Associations Providing Limited Service. The collective bargaining association and the cooperative terminal sales agency are well-known forms of cooperative sales organizations which perform only a single service for their members. The bargaining type of association has developed in the sale of certain products, such as fluid milk and sugar beets, which producers deliver directly to distributors or manufacturers and in the sale of which the bargaining power of the individual producer is quite ineffective. The pure bargaining association acts as a sales agent for its members and negotiates with the buyers as to prices and terms of sale. The producers, in turn, sign contracts with the association and agree to sell all of their product to buyers and dealers in accordance with instructions from the association and at prices agreed upon between the officers of the association and the buyers.

Cooperative sales agencies operating on the terminal markets are essentially commission agencies selling livestock consigned to them as advantageously as possible and remitting returns to the shipper. A number of other services, such as order buying, feedlot and pasture appraisals, financing, and market information, are provided the livestock producers in addition to sales. In recent years a number of cooperative livestock sales agencies have decentralized operations and are now operating auctions, and private treaty markets, as well as terminal facilities.

Cooperative livestock marketing agencies cannot be strictly classified as federated or centralized agencies, as most of them have some characteristics of both. Cooperative livestock commission companies are the most important of the sales agencies, but grains, fruits and vegetables, and eggs are also marketed in this way.

BUSINESS METHODS OF COOPERATIVES

Methods of Handling Farmers' Products

Three major types of business relationship exist between cooperative associations and their patrons. These are purchase and sale, agency, and pooling.

Purchase and Sale. In this type, the cooperative buys the goods outright from the members. Under this plan the grower usually receives the market price for his product, and the association bears the risk of carrying the product and of price fluctuations after it is purchased from the grower. If there are any margins remaining after the payment of authorized expenses and any limited dividends on stock, they are returned to the members on a patronage basis. Most local cooperative grain elevators operate on this basis, and it is also used by a large proportion of local cooperatives handling cotton and potatoes.

Agency. In the second type of business relationship, the association sells the product for the member as his agent, paying him the returns from his products after they have been sold and collections have been made. This method is widely used in the sale of livestock. Some grain, a considerable volume of cotton, and varying amounts of many other products are also sold in this way.

Pooling. The third type of cooperative handling of farmers' products is pooling, a device which has developed out of cooperative selling, and which is widely used. As defined by Bakken and Schaars, pooling "means the commingling of products of many producers and, after deducting average expenses, paying the average price received for the same, usually on a basis of established grades." [7] The actual products delivered by the members may be physically mingled, or their individual identity may be retained. When deliveries of individual growers are made in small lots it is usually desirable to handle the products of several or all members in a single lot, or in lots of a single grade, in order to gain the economies which result from grading, packing, storing, selling, and delivery in large lots. Grain sold to country elevators is usually pooled in this sense, even when the grower is paid cash on delivery, and receipts from the sale of cream and milk are commonly

[7] Henry H. Bakken and Marvin A. Schaars, *The Economics of Cooperative Marketing* (New York: McGraw-Hill, 1937), p. 442. See also Clyde B. Markeson, *Pooling and Other Grower Payment Methods*, General Report 67 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, December 1959), pp. 4–6.

pooled. When deliveries are made in larger lots and particularly when there may be advantages to some growers in having their products sold separately, as with cotton, or fruits and vegetables packed and sold in containers, the identity of the products of individual growers may be retained during the whole marketing process.

If products are not graded each grower is paid the average price realized by the association, less expenses. If they are graded as received, but are sold in a single pool, each grower is paid on the basis of the quality of the product he delivered. If each grade is sold in a separate pool, he receives a pro rata share of the net receipts for his grade. If the identity of his product is maintained, the grower receives the net receipts after deducting the expenses directly involved in selling his product plus his share of the general pool expenses which cannot be easily allocated to individual producers.

Pooling has developed particularly because it provides a means of spreading risk and equalizing sales returns to producers for equal grades. Farmers also believe it enables the association to gain for its members the economies of shipping, grading, and storing in large volume; to divide the members' products into graded lots which are large enough to warrant efforts to sell each grade for the price its quality warrants; and to avoid the trouble and expense of marketing each member's products separately. Pooling also facilitates attempts to market products in different markets and at different times, in order to "feed" the markets and thus avoid local gluts and shortages, and to avoid "dumping" a large volume at one time.

Sales Policies

Probably the most difficult problem that confronts any cooperative marketing organization is the development of an effective sales policy which will result in obtaining the highest possible price for the products it has for sale. In attempting to organize and develop a cooperative sales association, many producers have learned that the process of selling is much more involved than it has appeared to be when performed by the independent buyer, of whose operations and problems they had little knowledge.

Cooperatives normally sell to or through wholesale receivers, brokers, commission men, and auctions in the central markets or directly to large buyers, such as manufacturers, retail organizations, and public institutions. The large-scale cooperatives are of course in a better position than are local associations to bargain with the central market outlets and to sell directly to large buyers.

Membership Contracts

Often some definite and enforceable understanding about the relations of a member to his association, and particularly those relating to the handling of his products, has been found to be necessary to the success of cooperative associations, and membership contracts of various kinds have been used. The advantages of such contracts may be briefly summarized. The members have a clear understanding of what they may expect from their association, and each member is assured that he will receive the same treatment as his fellow members. The association is assured of the support and patronage of its members, usually for a definite period of time. This is necessary because the very existence of an association depends upon a continuous volume of business, and because it enables the management to plan future operations and to undertake financial obligations and commitments.

The marketing contracts commonly used today have developed from the practice of early associations which attempted to compel their members either to deliver their products to the association or to pay damages in the form of a "maintenance" or "penalty" fee.[8] Such fees proved difficult to collect and often antagonized the producers, and they have now quite generally been superseded by membership contracts. These, too, have tended to become more liberal as the cooperatives have gained experience, and more dependence is now placed on satisfactory service to hold the loyalty and retain the continued business of members, than on the legal power of ironclad contracts.[9]

RESULTS OF EFFORTS TO OBTAIN COOPERATIVE OBJECTIVES

Higher Prices

The objectives of cooperatives were divided above into those designed to increase the price paid to the members and those intended to lower the cost of marketing and production, all with the purpose of giving the farmer a higher net return on his product. The degree of success attained by co-

[8] The "maintenance fee" is discussed in Edwin G. Nourse, *The Legal Status of American Cooperation* (New York: Macmillan, 1927), pp. 173–83.

[9] Legal remedies for breach of contract are, however, available to cooperative associations. For a discussion of these and other legal aspects of the marketing contract see L. S. Hulbert and Raymond J. Mischler, *Legal Phases of Farmer Cooperatives*, FCS Bull. 10 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, January 1958), pp. 89–119.

operatives among farmers clearly depends upon the degree to which these various objectives have been attained. In spite of keen competition with independent marketing agencies, and sometimes even in the face of their individual and organized opposition, the cooperative efforts of farmers have had a wide measure of success and have resulted in real and tangible benefits. Some indication of the measure of this success can be seen by a brief consideration of the degree of success or failure in achieving the various objectives.

The Development of Orderly Marketing. Efforts to stabilize and enhance the prices obtained by members through orderly marketing are important activities of many cooperatives. In order to attain this objective, associations sometimes attempt to influence production so that it will accord more nearly with the demands of the market. Attempts are also made to control the marketing of the crop so that commodities will go to the best markets at the most favorable times. A third activity is the attempt to control the seasonal flow of a product to all markets. In the degree to which such efforts are successful will gluts and shortages tend to be eliminated, whether they be seasonal or temporary.

The larger the proportion of a given crop which a cooperative controls the more successful it is likely to be in the development of orderly marketing. In most cases, of course, cooperatives control only a small percentage of the total volume of a commodity offered for sale. Nevertheless, they have frequently been successful in their efforts to make advantageous market contacts, and by intelligent study of market conditions they have endeavored with some success to market their products at the best time of year and to sell in the best markets at a particular time. To do this successfully involves judgment, and larger associations are more likely to have executives who are experienced in marketing and able to use good judgment than are individual producers, or local associations, or even many local independent middlemen.

To sell in the best market at a particular time is especially important with perishable commodities. The large fruit and vegetable organizations, for example, by keeping in touch with various markets and sending their products where the demand is greatest and the price highest at a particular time, have been able both to effect considerable savings for their members and to broaden their markets.[10]

Better Selling Methods. Those associations which sell a nonstaple product such as fruits and vegetables consumed directly by the final consumer have been particularly active in improving the sales promotional methods for their product. By means of advertising, the use of brand names, and other

[10] For an example see R. D. Tousley, "Marketing Washington Apples," in Nathanael H. Engle (ed.), *Marketing in the West* (New York: Ronald, 1946), pp. 124–33.

selling devices they have tried to increase the total demand for the products they sell. Thus Sunkist oranges, Land O'Lakes dairy products, Ocean Spray cranberries, Welch's grape juice, Sioux Bee honey, and Diamond walnuts have become nationally known trade names and have achieved a strong consumer acceptance. Not many private middlemen selling such products could afford such large promotional efforts as are made by these cooperatives. Since these efforts increase the selling expense of the cooperative over that of other private competitors, their justification must be determined by the sales results. These are difficult to measure, but it seems clear that in many such cases cooperative promotional efforts have been successful in increasing the total sales of the farmers' product.

Improved Quality and Better Grading. Closely related to the efforts to improve selling methods has been the cooperative emphasis on improved quality and better grading. The local buyer of farm products often pays a flat price regardless of quality, or grades products roughly, thereby overpaying producers of low-quality goods and underpaying the producers of superior products. Farmer cooperatives have done much to eliminate such practices. By encouraging farmers to grow high-grade products of uniform quality and then seeing to it that the individual farmer gets the proper price for the particular grades he has produced, cooperatives have helped to raise the average price received by their members for their product. This encouragement to farmers to grow high-quality products has been important not only to producers of products directly consumed by final purchasers, but also to the producers of staple products such as cotton and tobacco.

Cooperatives have frequently pioneered not only in the development or improvement of systems of grading, but also have improved methods of packing and shipping and encouraged the development of facilities for more effective and more economical means of producing good products. They have been instrumental, for example, in the development of X-ray methods of inspecting fruit, the use of electric eyes in sorting beans and other products, and improved dairy and creamery machinery. Thus by emphasis on careful grading, quality production, and careful processing, the cooperatives have been able to encourage farmers to produce the types of products desired by consumers and so to enable the growers to receive better prices.

The Reduction of Trade Abuses. Cooperatives have sometimes been helpful in reducing or eliminating trade abuses. Thus the actual or potential competition of cooperatives has frequently been instrumental in inducing private dealers to pay more attention to proper grading in buying from farmers. Farmers have sometimes claimed as a justification for forming a cooperative that buyers had agreed to keep the price of their products low and a co-

operative was necessary for them to be sure of receiving the full price. Cooperatives have also been responsible for the elimination of certain abuses in the charges for handling and selling produce in the terminal markets, particularly in livestock. Thus the competition of cooperative associations has often had the effect of forcing independent agencies to pay better prices and give better service. It has been asserted that, as cooperation has gained and shown its strength, the desired ends have often been gained merely from the independent shipper's knowledge that he is constantly competing with a potential competitor in the association which the farmers may organize. Thus the cooperatives perform a service which benefits both members and nonmembers.

Increased Bargaining Power. An individual farmer is likely to be at a disadvantage when dealing with a buyer. He is not a specialist in buying and selling as is the dealer, and moreover he is only one seller with a small volume relative to the total purchased by the buyer. Thus the common situation in agricultural buying has been that of many small sellers facing a small number or sometimes one buyer, with the advantage clearly on the side of the buyers. The development of cooperatives has tended to balance this market situation by permitting farmers to combine and offer their product through their association. Not only do they have a larger volume to offer in this way but also can afford the services of a manager skilled in selling. While increased bargaining power has been of some significance for most cooperatives, it has been of particular importance in the marketing of milk and of fruits and vegetables. There are many associations in these fields which have as their sole or principal function bargaining with buyers as to the price of the product.

Price Fixing. Occasionally cooperatives have attempted to raise the price of their product by monopolistic activity. Major efforts in this direction were those of the centralized cooperatives formed during the period after 1920 in cotton and tobacco. The promise was held out to farmers suffering from the price collapse after World War I that, by joining in cooperative action, they could control the price at which their products were sold. Experience showed, however, that it is impossible for any period of time to obtain by voluntary means the limitations on output necessary to maintain prices. Many of these associations failed or converted to other objectives. Cooperatives have also at times attempted to hold products off the market in order to influence prices or to wait for a rise in price at a later time. This is highly speculative and has resulted in large losses for many associations. The enormous losses of the grain and cotton stabilization cooperatives organized under the influence of the Federal Farm Board for this purpose show the dangers of this

procedure.[11] In the light of these experiences cooperative leaders have recognized that monopoly control is not an appropriate goal of cooperatives.

Lower Costs

Cooperatives have also endeavored to increase the return for the farmer's product by lowering his costs so that more of the final gross price is left with the farmer.

Improved Marketing Methods. By various means farmer cooperatives have endeavored to improve methods of marketing so as to narrow the spread between terminal and local prices. This they try to do directly by reducing the cost of marketing to terminal market buyers, with the growers profiting in higher prices at the time of sale, or through patronage dividends, or both. By efficient management and loyal cooperation they have often been able to achieve this objective and at the same time furnish more and improved marketing services.

This is not always the case, however. There is little reason to believe that a local business organization which is cooperatively owned and operated can perform the marketing services more economically or more effectively than can a privately owned organization of the same size. Managerial expenses, labor and other current expenses, depreciation, and interest on investment are likely to be much the same. In either case effective management is largely responsible for success. But conditions in a community may, nevertheless, be such that the producers profit by marketing cooperatively. When, for example, one large cooperative replaces a number of competing local dealers, none of which has a large enough volume of business to operate economically or effectively, real economies may be effected, and improved service may result.

Again, in communities where existing marketing facilities are inadequate, the organization of a cooperative may not only reduce the cost of marketing but improve the marketing services. For example, where local marketing facilities are inadequate, growers may find it necessary to market their own products through sale or consignment to the processor or retailer, or central market dealer. At such points cooperation may accomplish results similar to those which follow the establishment of an independent middleman: that is, transportation costs may be lowered by the combination of shipments into carload lots; individual farmers are relieved of the bother of attending to all the details of marketing their own products; and the knowledge and bargain-

[11] The Federal Farm Board experience is described in Chap. 30.

ing skill of a market specialist are substituted for the limited knowledge and skill of the average farmer.

Occasionally the obtaining of the middleman's profit for the farmer is said to be an objective of cooperation. This, however, is seldom of a size to be significant to the individual farmer unless, as farmers sometimes claim, the middleman's margin has been exorbitant because of monopolistic arrangements or other trade abuses.

Thus the main advantages of cooperatives in lowering the costs of marketing to the farmer seem to lie in situations where for one reason or another private initiative has supplied inadequate service, private middlemen are too small to perform the services needed at low cost, or there are trade abuses. Where size is similar and management effective the marketing costs are composed of similar items, and little difference in cost to the farmer can be expected to appear.[12]

Lower Costs of Production. A growing phase of the effort to increase the returns of the farmer through cooperative activity has been the development of various ways to decrease his production costs. Many cooperatives primarily concerned with marketing have also established departments to buy supplies for their members. In other cases cooperatives have been established whose sole or major purpose is the purchase of farm supplies for their members.[13] The expectation is that the supplies purchased cooperatively will be closely tailored to the farmers' needs, and that the cost will be low because of large-scale buying. For example, many cooperatives mix fertilizer or feeds on a large scale to the most desirable specifications in an effort to give the farmer what he wants at as low a cost as possible. Other important items purchased by farmers cooperatively include petroleum products, seed, building materials, and farm machinery and equipment.[14] In many cases cooperatives have gone into the manufacture of such supplies.

[12] There will be some items on which differences will appear. The cooperative usually has no direct expense for obtaining the business of its grower members, whereas the private organization must frequently spend a considerable amount of time and money in this way. On the other hand, the cooperative does have large organization expenses, and its expenses for "educating" the members concerning its activities, in order to maintain their loyalty and retain the business, may be considerable. Whether these expenses are less than the business promotion expenses of private organizations will vary with associations.

[13] See Joseph G. Knapp and John H. Lister, *Cooperative Purchasing of Farm Supplies*, Cooperative Division Bull. No. 1 (Washington, D.C.: Farm Credit Administration, 1935); and *Farmer Cooperatives in the United States*, Bull. 1 (Washington, D.C.: Farmer Cooperative Service, 1955), pp. 139–69.

[14] See Anne L. Gessner, *Statistics of Farmer Cooperatives*, 1957–58, General Report 76 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, June 1960), pp. 46–59. Of interest in showing the size and scope of some of the major purchasing cooperatives is J. Warren Mather, *Handbook on Major Regional Cooperatives Handling Farm Supplies, 1957 and 1958*, General Report 74 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, February 1960).

Some cooperatives also give direct assistance to their members in the process of production. One aspect is the supplying of experts to give advice on various phases of production. Another is the supplying on a cooperative basis of very expensive machinery, such as spraying or harvesting machinery, which members could not otherwise afford to use.

GOVERNMENT ASSISTANCE TO COOPERATIVES

Government assistance has been important to the development of cooperatives. Some aspects of governmental relations with cooperatives have been merely permissive while others have been promotive.

Legislative Assistance

State Laws. Because there were no laws peculiarly adapted to cooperative organizations, the early associations were either unincorporated, and operated by mutual agreement, or when incorporated, conformed to the ordinary corporation laws. Such devices became increasingly unsatisfactory, and in response to a growing demand the states began passing special acts, under which the important features of cooperative organization could be enforced. Each of the 50 states now has statutes for the incorporation by farmers of cooperative marketing associations. Most of these state acts were passed to help farmers' marketing associations. Some of them make no mention of consumer cooperatives; others have some parts referring to consumer cooperatives, and to farmers' purchasing associations. There is, however, considerable uniformity among the present state cooperative marketing laws, since many of them copied rather closely the law known as the Bingham Act, passed by Kentucky in 1922.[15] These laws have been important to the development of cooperatives since they made it possible to operate under laws designed specifically to accommodate their typical procedures, rather than under laws designed for another form of business operation.

Federal Legislation. The federal government is committed to the principle of encouraging the cooperative marketing of farm products, and has not only recognized the need for it but has taken definite measures at various times to aid its development. This is evidenced by such acts as the Capper-Volstead Act passed in 1922, which defines cooperatives and their rights in interstate commerce; the Cooperative Marketing Act of 1926 which provides

[15] A review of the significant provisions of this Act will be found in Donald F. Blankertz, *Marketing Cooperatives* (New York: Ronald, 1940). The complete Act is given in Hulbert and Mischler, *op.cit.*, pp. 301–9.

for an agency in the Department of Agriculture to carry on research, service, and educational work for cooperatives; and the Agricultural Marketing Act of 1929 under which the Federal Farm Board undertook the active promotion of cooperatives on a national scale. With the closing of the Farm Board era in 1933, the federal government has been less active in the field of agricultural cooperation. Its chief activities have been confined to financial aid through the Banks for Cooperatives, and the activities of the Farmer Cooperative Service which carries on research and offers advisory services and educational assistance in the fields of marketing, farm supply, and related service cooperatives. The Service publishes material of use to cooperatives and helps farmers to solve organizational and operating problems of their cooperatives.

Federal Income Tax Treatment of Farmer Cooperatives

An aspect of the relationship of the federal government to farmer cooperatives which has attracted much attention in recent years is the income tax treatment of farmer cooperatives under federal law. Farmer cooperatives meeting certain restrictive conditions on the type of business done, relationships with nonmembers, and method of distributing profits may qualify for income tax exemption. These conditions are spelled out in Sections 521 and 522 of the Federal Internal Revenue Code and the interpretations and rulings of the Internal Revenue Service and the federal courts. They may be summarized as follows: (1) substantially all voting stock must be held by current patrons; (2) dividends or interest on capital must be limited; (3) business must be limited to the marketing of farm products or the purchasing of farm supplies; (4) no more than half the total business may be with nonmembers, nor more than 15 per cent of the business in supplies may be with nonfarmers; (5) members and nonmembers must receive equal treatment; (6) no reserves may be maintained unless they are required by state law, or are for a necessary purpose and reasonable in amount.

Since the Revenue Act of 1951, even a cooperative meeting these requirements is not exempt from income tax on any receipts over and above certain deductions including dividends on capital stock and amounts paid or allocated to patrons on income derived from nonoperating transactions with nonpatrons plus the patronage dividends paid or allocated to each patron. Cooperatives not meeting these conditions pay regular corporation rates on their net incomes. However, if a cooperative obligates itself in advance to pay patronage refunds they may be excluded from gross income, often leaving even nonexempt cooperatives with little or no taxable income.

Opponents of this approach claim that it represents unfair discrimination against the private competitors of cooperatives. Cooperatives are said to perform substantially the same services for farmers as do private firms without offering special organizational or service features warranting a different tax treatment. Yet cooperative tax advantages, particularly in the accumulation of capital, are claimed to be so great as to threaten the existence of competing private firms. Cooperatives, however, maintain that no undue advantage arises from present income tax procedures which are said to be justified and made necessary both by their form of organization and type of service.

LIMITATIONS ON THE DEVELOPMENT OF COOPERATIVE MARKETING

It is clear from the preceding discussion that cooperatives have met with considerable success in attaining their objectives in some cases while in others their efforts have not been so successful. In addition to the particular difficulties encountered in attaining the various objectives just discussed, there are certain broad limitations relatively common to cooperative marketing organizations which must be overcome if cooperatives are to be successful.[16]

Management Problems

Perhaps the most important factor in the success or failure of a cooperative is the quality of its management. While there have been a number of outstanding men in farmer cooperatives, too often farmer cooperatives have been handicapped by a lack of understanding of the necessity of good management. This is often the result of a general lack of experience on the part of members and directors in the type of business operations they are undertaking. Farmers themselves have often been unable to direct the organization properly because of the lack of time or ability. They have frequently been unwilling, moreover, to pay enough to hire a capable manager.[17] Education through experience, through state associations, cooperative publications, and the efforts of the farm bureaus, of state colleges of agriculture, and the

[16] Good discussions of the types of difficulties faced by farmer cooperatives are in Raymond W. Miller and A. Ladru Jensen, "Failures of Farmers' Cooperatives," *Harvard Business Review*, Winter 1947, pp. 213–26; and "Some Reasons Why Farmer Co-ops Fail," reprinted from *News for Farmer Cooperatives*, Reprint 149 (Washington, D.C.: Farmer Cooperative Service, U.S. Department of Agriculture, January 1958).

[17] The farmer's net cash income is often relatively small compared to his real income. A large part of his real income—such as house, use of his automobile, and garden—he does not always consider a part of his income. The salary demanded by a good manager often seems to him, consequently, to be excessive.

United States Department of Agriculture has done much to reduce this difficulty in recent years.

Membership Problems

Lack of loyalty on the part of members to the association is frequently a limitation on cooperatives and may prove fatal. The association in planning its investment in plant and equipment and in making its commitments for supplies and to buyers must be able to count on a given volume of business from its members. If members are easily influenced to market through other channels, either because they feel they can do better marketing on their own or because a competitor of the cooperative makes an especially attractive offer, the association will be handicapped by inadequate or uneven volume and inability to carry out plans.

A problem of membership loyalty which has frequently caused difficulty and sometimes failure for cooperatives is the fact that many farmers dislike pooling. For various reasons such as the high cost of handling members' produce individually, upgrading by mixing produce, and orderly marketing at advantageous times and places, many cooperatives find it advantageous to pool their members' products. Farmers may object to this, for example, if their product is of a higher grade than the highest grade sold by the cooperative so that they lose by having their product mixed. More often individual farmers will feel that if they had chosen the time of sale for their own products the price would have been higher than the average price which the pool received over the period of sale. This feeling is particularly prevalent during periods of declining prices. Again many farmers object to waiting for their return and also to the uncertainty as to the price which they will finally receive. To try to meet these objections cooperatives have worked out various modifications such as dividing into early, middle, and late pools, or giving the farmer the option of withdrawing at any time. In spite of such improvements in pool operation, however, the dislike of pooling, even where it seems necessary to effective cooperative marketing, remains as a limitation on cooperatives.

Finally, members must be willing to stand by their cooperative during periods of adversity. Among significant membership handicaps to cooperative success are: lack of appreciation of the difficulties involved; overemphasis on the possibilities of success by promoters, which causes members to expect the impossible; inexperience in cooperation; ignorance of the ultimate advantages; and unwillingness of growers to limit their independence of action.

Inadequate Business Methods

Closely related to the problems of lack of good management and lack of membership understanding, is the problem of inadequate business methods as a limitation on cooperative development. Farmers frequently find it difficult to understand the basic requisites for satisfactory operation of a business such as the necessity to begin with sufficient capital, the need to maintain adequate reserves even at the expense of patronage dividends, the necessity of adequate records, and the problems involved in credit and collection policy. Insufficient attention to such business essentials has often prevented the development of a cooperative to its fullest potential or has resulted in failure.

External Conditions

A difficulty which besets almost every cooperative, and is frequently a contributing cause to failure or lack of complete success, is the competition of independent middlemen. That middlemen should endeavor to retain the business which a cooperative association is trying to attract from them is perfectly normal. But cooperatives sometimes claim that they are faced with unfair and even underhanded methods of competition. They charge their competitors with paying higher prices than the market warrants, and sometimes making up by reducing prices at other points; of buying into associations to cause dissension; and of circulating and even publishing false reports. Moreover, commercial interests not directly competing with cooperatives are sometimes unfriendly. The active opposition of railroads, bankers, manufacturers, and merchants can do much to weaken and undermine an association. Nevertheless, competition and outside opposition are seldom basic causes of failure, though they may occasionally contribute to difficulties.[18]

More important to the success or failure of the cooperative are the external conditions surrounding the establishment of the association. Too often cooperatives have been established where the existing dealers were giving excellent service at a reasonable profit. Or cooperatives specializing in the marketing of particular products, say eggs, have been formed where there was not an adequate volume of production within reasonable distance. Two authorities within the cooperative movement have summed up these problems by saying, "Only when existing commercial facilities and services are

[18] "In view of the large number of cooperative organizations to which questionnaires were sent and the proportion answering the same, very few cases were developed in which it appeared that outside interests have interfered or were interfering with their successful operation. . . . existing Federal Laws afford such organizations ample protection in all cases where jurisdiction exists." *Report on the Grain Trade,* Vol. I (Washington, D.C.: Federal Trade Commission, 1920), pp. 297–8.

inadequate or cost the producers too much for the services rendered, and when adequate membership, capital, volume of business, and market outlets can be secured, are the conditions favorable for the creation and continuance of a marketing or purchasing cooperative attuned to the needs of its prospective patrons." [19]

It is noteworthy that the most spectacularly successful associations seem to have been those which met the conditions just described and in addition offered a nonstaple product for which there was the possibility of expanding the demand by effective advertising and sales promotion. Particularly good examples of this additional condition are those cooperatives on the West Coast marketing such products as citrus fruits, apples, raisins, walnuts, and eggs. It is evident, however, from the success of cooperatives in other fields that possibilities for demand creation are by no means an essential condition for effective operation.

CONCLUSIONS

Farmer cooperatives have attained a position of considerable, although varying, importance in the marketing of farm products in the United States. Where successful they have helped to increase the income of their farmer members by their operations. This they have done by raising the price received by the farmer through such methods as orderly marketing, better selling methods, increased bargaining power, and improved quality and better grading, and also by helping to lower the farmers' costs by improved marketing methods and the cooperative purchase of supplies.

At the same time it is evident that there are important limitations on the future progress of cooperatives in the form of such things as inefficient management, lack of membership understanding and loyalty, inadequate business methods, and unfavorable external conditions. While many of these limitations are to a considerable extent at least potentially under the control of the cooperatives, they nevertheless represent important limitations on further expansion of cooperative marketing unless successfully met. Thus while cooperatives may be expected to remain and perhaps increase as an important factor in the marketing of farm products, it seems unlikely that they will soon become the dominant factor in the agricultural marketing structure.

QUESTIONS FOR DISCUSSION

1. What similarities and differences are there between a farmer cooperative, a consumer cooperative, and a business corporation?

[19] Raymond W. Miller and A. Ladru Jensen, *op.cit.*, p. 215.

2. What are the differentiating characteristics of local, federated, and centralized associations?
3. Why is pooling a peculiarly cooperative form of handling farmers' products?
4. Why would a farmer join a cooperative?
5. Describe the differences and similarities in the policies you would follow if you were the manager of a cooperative selling a nonstaple product grown regionally in comparison with a staple product grown nationally.
6. What major limitations do you see to the further development of cooperative marketing?

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PART V

THE MARKETING FUNCTIONS

18. SELLING

The functions of marketing were discussed briefly in the first chapter, and the importance of the functional approach was indicated. In the intervening chapters, reference to the marketing functions has been incidental to the general discussion of the marketing structure and the nature of the marketing system. With this background, we are now ready to examine the functions of marketing in a more orderly and systematic way, indicating something of the nature and importance of each function, how and by whom it is performed, and some of the problems involved. The discussion in the space permitted cannot be exhaustive, but it will be indicative of the major activities performed during the marketing process: selling, buying, transportation, storage, financing, risk-taking, the collection and interpretation of market information, and standardization.

The first two functions, selling and buying, constitute the functions of exchange. It is through the efforts of sellers and buyers that exchanges of title are brought about, that the physical distribution of goods is guided, and that demand and supply interact to determine prices. The impetus to a sale may come from the efforts of either buyer or seller, but in modern industrial countries the seller is the more active party to most exchanges. Selling efforts have probably always been necessary to successful marketing, but, as marketing has grown more complex and the competition for sales has become more intense, selling has become increasingly important. Indeed, it is the most characteristic feature of the modern marketing system.

The objective of selling is to dispose of goods at satisfactory prices. The nature of selling operations varies widely with different products and with individual vendors. In some exchanges only the immediate act of transferring ownership takes place and no active selling operations are involved. Some selling operations consist merely of exhibiting goods at a convenient place, or of informing prospective buyers that goods are offered for sale. Modern

selling, however, commonly involves the following five subfunctions: (1) product planning and development, (2) the contactual, (3) demand creation, (4) negotiation, and (5) the contractual. In the discussion that follows, considerable attention is paid to the marketing activities involved in the first three of these subfunctions. The negotiatory and contractual subfunctions need not be treated in detail.

Negotiation involves the final establishment of the terms and conditions of sale for each transaction including terms of shipment and delivery, method of payment, the exact quality and quantity to be purchased, and similar matters. The contractual function is concerned with the final agreement to sell, including the transfer of title. Necessary as these two functions are, they represent essentially the final termination of the entire selling function. Much of the main work of selling has already been accomplished through the activities involved in product planning and development, in making contacts with buyers, and in creating demand. Negotiation and the entering into the final contract in many instances become relatively routine matters of procedure, although negotiations with business buyers, especially if large quantities of goods are involved, may be both prolonged and complicated.

PRODUCT PLANNING AND DEVELOPMENT

All those activities involved in devising a product to meet the requirements of the market are classified under the function of product planning and development. Successful selling in a competitive market rests fundamentally on the production of commodities that fit the needs and requirements of potential consumers as they see them. The production of such products commonly results from the careful analysis of the needs and desires of consumers. Product planning by the manufacturer involves the creation of new products to fill both old and new wants, the development of changes in old products to make them conform to changes in consumer demand, and the suggestion of additions to or subtractions from the line in order to realize greater profits. Product planning also involves certain activities performed in connection with the product, such as identification by the use of a brand and the design and use of a proper package. Product planning and development thus involves many marketing activities and is definitely a consumer-oriented function.

The responsibility for the performance of this function lies generally with the manufacturer except perhaps for those products which large retailers and wholesalers sell under their own brands. In these cases, the distributors involved are likely to assume the function of product planning and

development. There are, of course, some instances in which the product desired is designed by the buyer, either the business buyer or even the ultimate consumer, and is produced to this specification by the manufacturer. However, for most products in an industrial economy, the function of product planning and development is performed by the manufacturer.

Development of a Line of Products

The first problem is to determine exactly what product or products shall be produced and what features shall be incorporated in their design. Product design in the past has often been regarded as a function to be performed solely by the manufacturing and engineering departments of an enterprise, but this view is becoming outmoded. The marketing department is closer to the consumer and has more knowledge of his desires. In addition, many product decisions must be made which involve matters of marketing policy.

Variety of Products. One of the first decisions to be made involves the variety of products that will be produced. Shall the attempt be made to satisfy all of the various demands of the market or shall the company cater only to a limited segment? The answer to this will determine the variety of models, of sizes, of colors, and of patterns to be offered. For some products and for some sellers, it is best to concentrate production and marketing efforts on one product, obtaining the economies that result from such a policy. In other cases, a different policy is indicated by the character of the demand, of the product, and of the seller's objective. In the late fifties, Volkswagen appeared to be highly successful, in relation at least to its objective, in selling in the United States a single unchanging model of automobile. In an earlier day, the Ford Motor Company also used this policy very successfully for a while, but it finally was forced to change its policy to that of the remainder of the American automobile industry—the offering of a wide variety of models, colors, and types under a single brand name.

Quality of Product. Similar to the above problem is the question of what quality of product to offer and whether to offer more than one quality. Many producers restrict their product line to a single quality offering. This may be a product of high quality designed to sell at a premium price, a product of average or market quality designed to sell at a standard market price, or a product of less than average quality designed to sell at a price below the general market level. Which of these three policies should be adopted depends upon a number of factors, including market conditions as well as the resources and objectives of the particular firm.

The problem may arise, in connection with the firm offering a single

quality of product, of whether to add either a higher or lower quality product. For example, the manufacturer of a high quality paint may feel that he can extend his market by developing a second line of lower quality. His present product has an excellent reputation, and he feels that this reputation will help to sell the new line, i.e., have a "trading-down" effect. In like manner, the manufacturer of a well-known cheap watch may decide that he should expand into the higher quality field, depending upon the reputation of the cheaper product to have a "trading-up" effect that will help to sell the higher priced product. Trading-up and trading-down effects tend to work in various ways and not always to the benefit of the seller. There is always the danger that the addition of a lower quality line will ultimately reduce the sales of the original high quality product. Likewise, the manufacturer of the well-known cheap watch may not be able to convince buyers that his new product is indeed one of high quality. Accordingly, many producers, in adding products of different quality, find new brand names for the new items and do not attempt to trade on the reputation of the existing product.

Simplification and Diversification of Product Lines. There appears to be a natural tendency in a dynamic economy for sellers to diversify their product lines. There are several logical reasons for this. In the first place, new technological developments create new products. Thus the development of television resulted in the addition of television sets to the product lines of radio manufacturers, who continued to manufacture and sell radios on a substantial scale. Secondly, successful firms are looking constantly for new products that will appeal to new customers, thus creating new markets and reducing the elements of risk inherent in a narrow product line. The producer is always faced with the possibility that changing fashions and changing consumer tastes may leave him without a market for a certain product line. The more diversified are his product lines the less is the risk involved of this occurrence. Finally, new products promote growth, often an objective in itself, and increase the utilization of the firm's plant capacity and its financial and manpower resources.

Since the late forties, there has been a substantial movement toward product diversification. Much of this has been accomplished through the merger of existing firms, but a significant portion has come about simply by the addition of product lines to those already being produced. No doubt, many of these product additions have been made successfully,[1] but some of the

[1] One study, however, indicated that 80 per cent of the new products introduced by 200 packaged-goods manufacturers failed for reasons other than lack of capital. See Thomas A. Staudt, "Program for Product Diversification," *Harvard Business Review*, November–December 1954, p. 121.

failures illustrate the problems involved in diversification and the advantages of simplification.

There is no doubt that there are many economics to be derived from simplification. Less capital is tied up in inventories, manpower tends to be utilized more efficiently as a result of specialization of effort, and manufacturing and marketing activities can be directed more effectively. Thus diversification is most likely to succeed as a policy when the new products are closely allied to existing products and when a continuing effort is made to eliminate products as they become obsolete and unprofitable. Diversification creates many problems, however, when the new products are so different from the existing ones that new marketing methods and new channels of distribution must be used.

For example, a flour miller and breakfast cereal manufacturer found it unprofitable to diversify into small electrical appliances. Its principal difficulty was to obtain and keep dealers in competition with the regular appliance manufacturers who could furnish dealers with more complete lines.[2] Similarly, two manufacturers of industrial chemicals selling primarily to the industrial market have given up their attempts to become established in the consumer products field.[3] Although they successfully entered the field with detergents, they apparently decided after several years that it was too difficult to adapt their marketing efforts to the type of competition with which they were faced. On the other hand, another industrial chemical firm apparently has been quite successful in marketing a new food wrapping product to the ultimate consumer.[4]

Use of Brands

A brand is a name, term, symbol, or design, or a combination of these, which identifies the goods or services of a seller. "Brand" is an all-inclusive term, including brand names, designs, and symbols. In practice, it is often used interchangeably with the term "trade-mark." Trade-mark, however, is a legal term and is merely a brand that is given legal protection.[5]

[2] See Hector Lazo, *Case Histories of Successful Marketing* (New York: Funk & Wagnalls and Printers' Ink Publishing Company, 1950), pp. 162–8; and "End of Lesson," *Business Week*, May 22, 1954, p. 60.

[3] See "Monsanto Yields Consumer Field," *Business Week*, June 1, 1957, p. 36.

[4] See Parker Frisselle, "Product Diversification—Promise or Pitfall," in *The Marketing Revolution* (Proceedings of the Thirty-seventh National Conference of the American Marketing Association, 1955), pp. 23–7.

[5] See *Marketing Definitions* (Chicago: American Marketing Association, 1960), pp. 9–10.

Objectives of Branding. The general purpose of a brand is to provide product identification for assistance in buying and selling. The objective of the seller is to differentiate his product from those of competitors and to achieve as great a degree of market control as possible. If he is successful in creating a consumer preference for his product, this preference will be translated into sales in the market place only to the extent that the consumer is able to identify the desired product. Thus the use of brands constitutes the basis for successful demand-creational activity. The use of a brand, and the creation of consumer preference for it, also gives the seller greater independence in pricing his product. He may be able to obtain a premium price in relation to the prices of competitive products; in any event, he has more freedom in his efforts to adjust prices to market demand.

Problems of Branding. The first decision the seller must make is whether to brand his product at all. Some products are not readily adaptable to branding. To be useful, the brand must carry through to the ultimate consumer. Although apples, for example, are often distributed through wholesale channels in boxes that bear a brand name, they are usually removed from these boxes in the retail store, and the brand is not available to the consumer. In the case of oranges, on the other hand, a method has been developed whereby the brand can be stamped on each orange, and this product has been sold successfully by brand name.

Even if the product is capable of being branded, the seller may prefer not to designate a brand name. If the product is not distinctive, or if the seller does not desire to develop a degree of market control, he may prefer to sell the product unbranded. In some cases, manufacturers prefer not to use their own brand names but to sell to distributors who will place their brands upon the product. As noted in Chapter 15 many distributors, large wholesalers and retailers, in an effort to obtain market control and greater profit, have developed their own brands which compete directly with the brands of manufacturers, the latter usually being sold also by these same distributors. Distributors' brands are often called "private" brands, whereas those of manufacturers are designated as "national" brands, terminology that is by no means exact.

Once the seller has decided to brand his product, he must choose the brand with care. The name should be distinctive but simple and should not infringe upon some other legally established brand. If the seller produces or markets more than one product, he must decide whether to use different brand names for each product or whether to adopt a "family" brand ap-

plicable to all. The adoption of the family brand may make it easier to introduce a new product at a later time and may reduce the cost of demand-creational efforts since all products will receive the benefit of any promotional effort directed toward the single brand. On the other hand, it is usually not considered good policy to sell products of differing quality under the same brand name; and, in those cases in which the products are unrelated, many sellers prefer to use several brands. Swift & Company, for example, sells certain fresh and packaged meats under the brand name "Premium," but the name "Brookfield" is used for eggs, butter, cheese, and sausage. In both of these cases, the names indicated are preceded by the word "Swift's," which word in turn is the only brand designation used on canned meats for babies, on peanut butter, and on ice cream. Add to these designations "Allsweet" for oleomargarine, "Swift's Jewel" and "Swift'ning" for two types of shortening, "Pard" for dog food, "Vigoro" for a plant food used by urban dwellers, "Swift's Red Steer Brand" for a plant food for use by farmers, "Quick Arrow" soap flakes, "Maxine" complexion soap, and several other products with still different names, and we may conclude that branding is indeed a complicated marketing activity.

Packaging

The functions of a package are (1) to protect the merchandise from the time it is produced until it is consumed, (2) to facilitate handling and storage of the merchandise by middlemen and consumers, and (3) to assist in selling the product. Although the first two functions are important and probably constitute the principal reasons originally for the change from bulk selling to packaged-goods selling, the prime function of a modern package is to sell merchandise. Thus the package serves in most cases as the vehicle by which the brand of a product is carried through to the consumer. In modern self-service retail outlets with mass display, well-designed packages attract attention and increase sales volume. Packages are designed as much as possible to enhance the appearance of the product and, in some instances, to obtain sales as much on the merits of the package as on those of the product. Thus the modern manufacturer often pays as much attention to package design as he does to product design.

The basic decision to be made by the seller of whether to package his product is likely to be one that requires little thought. The trend toward the use of packages has been so substantial that it is almost impossible to ignore

it. Even fresh meats and fresh fruits and vegetables are sold in prepackaged form in a large number of food stores, the packaging in most cases being done by the retailer. Recent experiments at the packer level with the wax-dip method of packaging frozen meats indicate the possibility of even greater development in this field.[6] Thus the principal decisions to be made by the seller may well revolve around the questions of how to package and how often to change designs.

Questions that must be answered include the following: (1) out of the great variety of materials available for modern packaging purposes, which ones will serve best to enhance the appearance of the product, (2) what colors, designs, shapes, and sizes of packages should be used, (3) can a package be designed that will be particularly convenient for the consumer to use,[7] (4) can a package be designed with a dual use so that the consumer will buy the product at least in part in order to obtain the package for further use after the product it contains has been consumed,[8] and (5) to what extent, if at all, should special gift and novelty packages be designed for Christmas and other similar selling seasons?

It is not possible here to discuss the issues involved in arriving at solutions to these questions. The raising of the questions does indicate, however, the complexity of the packaging activity. This is also illustrated by two recent developments. The first involves the packaging of items into multiunit cartons in order to encourage the consumer to buy more at one time. This development was pioneered in soft drinks and beer with the "six-pack" carton. It has now been extended experimentally, apparently with some success, to other products, including canned corn, sardines, and pet foods.[9] No doubt many other products will be packaged in the same way. The second development is the policy of a few firms to change package designs at quite frequent intervals.[10] The traditional approach to package design has been to retain a design as long as possible because consumers would be familiar with it and would know what to look for when they desired to purchase the product. Now some firms say that the package should be changed as often as one's advertising copy is changed. If this idea gains in favor, the packaging function will assume even greater importance and complexity.

[6] See "Wax Dip Process Trims Meat Costs," *Business Week*, August 27, 1955, pp. 85–6; and "Visible Meat," *Business Week*, December 28, 1957, p. 109.

[7] As the "flip-top" or "crush-proof" package for cigarettes.

[8] The Kraft Foods Company has been particularly successful in this regard, packaging its products in "cocktail" glasses and in boxes that can be re-used for various purposes.

[9] See William L. Dempsey, Jr., "Multiple Packaging: A Merchandising Tool," *Journal of Marketing*, January 1959, pp. 287–92.

[10] See "Switching Packages to Keep Them Buying," *Business Week*, October 1, 1955, pp. 58 ff.

Concluding Observations

Other activities pertaining to product planning and development could be discussed, e.g., product guarantees and service policies, but the foregoing is sufficient to indicate the importance of the product planning function. Before the other functions of selling can be performed effectively, product planning must take place. Having discussed some of the marketing activities pertaining to the product, we may now proceed to a discussion of the other functions of selling.

THE CONTACTUAL FUNCTION [11]

Once the seller has a product or products available for sale, his next objective is to make contacts with buyers. The contactual function involves several steps. First, the seller must define his market. He must determine whether he desires to sell the product over a wide geographical area or whether a more limited distribution will serve his purposes better. Some sellers prefer to deal only in a very limited, local market. Others make contacts and distribute throughout the world. Another decision that must be made is whether to sell only to large buyers. It is often more profitable to refuse small orders than it is to accept and fill them. Other decisions regarding market coverage might include whether to concentrate contacts within certain income groups or within certain ethnic groups. Obviously, if restrictions of the latter types are to exist, the decision is usually made during the stage of product planning and development, and the product is designed specifically for a certain market.

Secondly, the seller, having defined his market, must seek out the buyers in that market. He must find out where they are located and what their needs are for his product. Finally, he must actually make contact with these potential buyers, develop a relationship of mutual interest, and continue to maintain the connection.

Selecting Distribution Channels

The contactual function is performed, of course, by all types of sellers: manufacturers and other producers, wholesale middlemen of all varieties, and retailers. The manufacturer or producer of a product must make the first

[11] For a detailed discussion see Edmund D. McGarry, "The Contactual Function in Marketing," *Journal of Business*, April 1951, pp. 96–113.

decision with respect to the performance of the contactual function. That is, he must decide the extent to which he desires to perform it himself and the extent to which he will attempt to turn it over to wholesale and retail middlemen. But if he decides to use such middlemen, it is by no means certain that he will receive cooperation from them. Limited facilities and personnel cause most middlemen to look with considerable skepticism upon the stocking of additional products. Thus the manufacturer must consider what *can* be done to obtain performance of the contactual function as well as what he would like to do. Whatever finally takes place, the result is the establishment of one or more channels of distribution for the product.

As we have seen previously, the manufacturer may decide to sell the product directly to the user, as is often the case with industrial goods. Or he may attempt to use wholesale middlemen, at least in part. A product intended for the ultimate consumer market may utilize both wholesalers and retailers, retailers only, or even occasionally neither. Even more specific problems are involved. Shall the product be sold only through a single type of outlet, such as grocery stores, or shall the effort be made to distribute through various types of outlets, including in addition drug and variety stores? Shall the manufacturer attempt to obtain widespread distribution in as many outlets as possible or shall he restrict distribution through a policy of selective selling or through the use of limited agencies or even exclusive agencies? These latter questions involving decisions as to the number of middlemen have many economic and legal aspects which warrant further discussion.

Selecting the Number of Middlemen

Manufacturers who feel that they must have their products available at every possible point of contact along the channel of distribution endeavor to place them with all middlemen who can sell their products effectively. For such manufacturers, the principal limitations to universal distribution are the ability to sell all available middlemen and the fact that the expense of selling certain individual firms may not be offset by the profits obtained from the volume of sales made. The first limitation is an obvious one, involving the sheer physical difficulty of making successful contacts with all possible buyers. The second is of varying importance, and its importance is not always realized by the manufacturer. It is evident, however, that a manufacturer cannot profitably sell to an account unless the gross profit on the merchandise sold covers the expenses involved in selling.[12]

[12] Manufacturers, of course, often sell to unprofitable accounts. In some cases, they do not realize that an account is not profitable. In other cases, they continue to sell with

The number of middlemen to whom a manufacturer sells is limited not only by the difficulty and expense of selling to them, but by the difficulty involved in obtaining their cooperation in the resale of his products. Many middlemen who may be induced to purchase his product will not devote as much sales effort to it as the manufacturer desires. One way to overcome this difficulty, as well as to obtain the business of desirable accounts, is to protect middlemen in their markets. Sometimes the middleman must carry a wide range of stocks, or he must supply expensive services, if sales are to be made in sufficient volume to satisfy both manufacturer and middleman. He is thus involved in considerable expense—an expense he will not undertake, at least to the extent desired by the manufacturer, without protection from the competition of other middlemen operating in the same area. To meet this situation various policies are followed, such as selective selling or the use of limited agencies or even exclusive agencies.[13]

Selective Selling. The restriction of sales to a limited number of middlemen within a market area is known as selective selling. This method of selling is distinguished by the fact that, within the limits of his ability to sell them, the manufacturer chooses the particular middlemen who are to be allowed to handle his product. In making the selection, he attempts to choose only those middlemen who are, or who will become, profitable accounts.[14] The degree of selectivity varies from manufacturer to manufacturer, and the proportion of the available middlemen that may be selected likewise varies. In adopting such a policy, the manufacturer hopes to reduce selling costs and increase profits. In addition he hopes that his chosen prospects will be more easily sold, and that once sold they will be more willing to devote attention to the sale of his product. Moreover, with fewer distributors or dealers, he can afford to spend more time in cooperating with them. If this cooperation is effective, a volume of sales will result which should be profitable to both the manufacturer and his selected middlemen.

Limited and Exclusive Agencies. A greater degree of limitation of accounts than that involved in selective selling is found in the use of limited agencies. The term "limited agency distribution" is difficult to define exactly but

the hope that the account will increase its purchases and become profitable or because it is necessary to do so for the convenience of the ultimate consumer.

[13] It should be pointed out that wholesalers, as well as manufacturers, may use these policies.

[14] More and more attention is being devoted to the matter of seeking profitable accounts, not only by manufacturers but also by wholesalers. Many manufacturers have found that the elimination of small orders and small accounts results in a substantial reduction in number of orders but only a very slight decrease in sales volume. In fact, sales volume usually increases because salesmen are directing their efforts to the customers with larger potentials. The result is often a very significant increase in net profit.

implies more restriction than is found in selective selling and less than that found in an exclusive agency policy. Many marginal cases are difficult to classify. The term is nevertheless useful to describe a policy adopted primarily for the purpose of achieving the advantages of the exclusive agency without limiting outlets so drastically as that policy does; whereas selective selling is more commonly adopted in order to reduce the expenses of effective selling. That either policy may achieve both aims in some degree does not alter the value of the distinction.

Limited and exclusive agencies are used in the sale of both consumer goods and industrial goods. In the sale of consumer goods, they are used by manufacturers with both wholesalers and retailers and also by wholesalers in their relations with retailers. The basic considerations involved in each situation are, however, common to all, and so the following discussion will be largely confined to the use of the exclusive agency in the manufacturer-retailer relationship.[15]

An exclusive agency [16] is based on an agreement between the manufacturer and the middleman whereby the middleman is given the sole right to sell the product or products of the manufacturer within a specified territory. Agreements may be written or oral and they are of two general types. In the first, the manufacturer agrees to sell to no other dealer in the specified area, and the dealer agrees to sell no directly competing lines. In the second type, the manufacturer agrees to sell to no other dealer, although the dealer may sell competing products. In such cases, however, the dealer usually agrees to give reasonable attention to the manufacturer's products.

The first type of agreement, which might be called a "fully exclusive agreement," would normally be more satisfactory to a manufacturer, but two important factors limit its use. In the first place, the manufacturer will find many desirable dealers unwilling to agree to an arrangement which prohibits them from handling directly competing goods. Secondly, there is considerable doubt as to the legality under the antitrust laws of these fully exclusive agreements.

There is no doubt that a manufacturer may restrict his own distribution and sell through a limited number of outlets. The legal question arises in connection with the manufacturer's attempt to restrict and regulate the ac-

[15] In order to prevent possible confusion in terminology, it should be noted that the term "agency" as used in the present connection does not usually imply an agency relationship in the sense used in describing agent middlemen in Chap. 16. Although the grantee of a limited or exclusive distribution privilege may be an agent middleman selling on a commission basis, he more commonly buys the merchandise outright and thus is a merchant middleman.

[16] For an excellent treatment of this topic, see K. J. Curran, "Exclusive Dealing and Public Policy," *Journal of Marketing,* October 1950, pp. 133–44.

tivities of dealers. In general, such restrictions may be illegal under the antitrust laws if the result is a substantial lessening of competition or a tendency to create a monopoly.[17] Prior to 1949, the courts held exclusive contracts to be illegal primarily when they were used by a dominant firm as a means of restricting competition. In 1949, however, in the *Standard Oil Company of California* case, it was held that Standard could not restrict its dealers from selling competitive products.[18] This decision was made despite the fact that Standard accounted for less than 25 per cent of the gasoline business in its area and that it was not guilty of other monopolistic practices. Although the court indicated that exclusive contracts as such were not illegal, especially when used by smaller firms, it seemed to believe that Standard, and other competitors who used the same device, were sufficiently large that they were foreclosing a large share of the market to independents. Thus injury to some competitors, rather than injury to the intensity of competition, has become the test of the legal validity of exclusive agency contracts.

It should be understood that this decision has not necessarily eliminated exclusive agency distribution even by large firms. Although restrictive provisions in contracts may have been eliminated, many manufacturers and dealers have continued to operate in much the same way as before. After the *Standard Oil Company* decision, the automobile industry generally rewrote its dealer contracts. The principal effect of this appears to have been that dealer sales are no longer confined to customers residing within the territorial limits that were once assigned to the dealers. Certainly, there has been no widespread movement by dealers to add competing makes of automobiles to their product lines.[19] Since exclusive agencies still exist, either on a formal or informal basis, it is desirable that the merits of this type of distribution be examined.

The Manufacturer and the Exclusive Agency. The question of primary interest to the manufacturer is whether greater sales volume and profit will result from the use of exclusive agencies than will accrue from sale to all dealers or to selected dealers. A sound answer to this question necessitates an understanding of the merits and limitations of the exclusive agency from the point of view of both the manufacturer and the middleman and the

[17] See William F. Brown, "The Effect of Federal Legislation upon Marketing Channels," in Richard M. Clewett (ed.), *Marketing Channels for Manufactured Products* (Homewood, Ill.: Irwin, 1954), pp. 485–90; also K. J. Curran, *op.cit.*, pp. 141–4.

[18] *United States v. Standard Oil Company of California*, 337 U.S. 293 (1949).

[19] There has been, however, considerable dissatisfaction among dealers as a result of the loss of their territorial security. Dealers complain that cross-selling has resulted in a chaotic price situation, as well as in servicing difficulties. See "Why Auto Dealers Want a Law," *Business Week*, January 18, 1958, pp. 75 ff.

ability on the part of the manufacturer to evaluate the relative importance of these merits and limitations in terms of his own specific situation.

The major advantages a manufacturer may obtain from the use of exclusive dealers usually are a better sales effort for his product, a lower marketing expense, and better "servicing" of his product. The better sales effort results from the greater cooperation secured from the exclusive dealer and his greater willingness to carry an adequate stock of the manufacturer's product and to devote more aggressive sales effort to the product. Marketing expense is reduced because efforts are concentrated upon a smaller number of dealers. The salesmen make fewer calls and take larger orders, and the amount of correspondence with and supervising of accounts is substantially lessened. The possibility of credit losses is reduced because cutomers are presumably preferred risks and can be carefully watched. On mechanical devices, such as automobiles, typewriters, and some electrical equipment, the use of exclusive agencies may result in better servicing of the product because the dealer more readily assumes responsibility for such service when he knows he is the exclusive dealer in a particular locality.

Among other advantages that may accrue to a manufacturer from the use of exclusive agencies are closer control over the pricing and other marketing policies of the dealers, the possible enhancement of the prestige of his product, and more effective introduction of new products. The resale prices of his product can be more easily maintained if that is desired, and in any case the evils which allegedly accompany price cutting are reduced. Prestige and good will for the product are built up, since consumers often associate quality and exclusiveness with restricted distribution. This is especially true when the chosen middlemen are among the more desirable dealers. The introduction of new products is facilitated because an exclusive dealer is much more willing to add a new line, and thus increase his investment in merchandise inventory, than would be true if he were only one of several dealers who would benefit from sales of the new product in the community.

The most important limitation of exclusive dealing from the point of view of the manufacturer, aside from its possible illegality, is that the restricted distribution may limit his sales in an area. Sales of his product by even the most desirable dealer in an area, assuming such dealer can be obtained, may not be as great as those which would result if the product were offered for sale in a larger number of establishments. Those dealers who do not handle the product will quite naturally attempt to substitute other brands for that of the manufacturer whenever his brand is called for. A second disadvantage of exclusive agency distribution is that the manufacturer is dependent upon the continued active sales efforts of his exclusive dealers. When more attrac-

tive terms are offered by other manufacturers, the dealer may terminate his agreement and sell a competing line. This often leaves the manufacturer without representation in that territory. Also when it becomes desirable to change exclusive dealers, the manufacturer may find it difficult to take the agency away from the dealer who has been handling the merchandise without some injury to the manufacturer's reputation in the trade. Even when agencies are terminated by mutual consent, difficulties are experienced in effecting settlements satisfactory to both parties, unless this possibility has been covered by definite stipulations in the original agreement.

The Middleman and the Exclusive Agency. The exclusive agency arrangement offers definite advantages to middlemen. The dealer is the sole beneficiary in his locality of the manufacturer's advertising, as well as his own. There are no competing dealers who can undermine profits by cutting prices, or who can otherwise attempt to draw away the trade in that particular product. Closer cooperation and greater assistance are received from the manufacturer than would be the case if a number of firms were selling his product in the same territory. The exclusive agent may gain prestige and standing in his community from being the exclusive representative of a reputable firm or a well-known line of merchandise. Also new customers may be brought to the dealer's place of business and sales volume may be increased. Consumers frequently buy other goods when they purchase the exclusive product, and new customers may be permanently acquired among those who come to buy it.

The limitations of the exclusive agency from the point of view of the middleman center largely in the possibility of abuse of the relationship by the manufacturer, the loss of independence of action, and the difficulties involved in changing to another line of products if it becomes desirable or necessary to drop the exclusive agency line. Dealers sometimes complain that after they have devoted their efforts to building up sales of the manufacturer's product in the area in which they are located, the right to sell the product is extended to other dealers or taken away altogether. But there is another side to this argument. Some dealers prove to be poor representatives, and some dealers obtain an agency and then push the sale of competing products, including their own private brands.

When the manufacturer is strong, he may dictate some of the dealer's policies, and independence of action may be lost. This is well illustrated in the determination of the amount of stock to be carried by the dealer. The manufacturer, of course, is anxious to sell as much as possible and believes that sales possibilities are enhanced if a full and complete assortment is

stocked. This also forces the dealer to greater effort. The dealer, however, may be unwilling to carry the necessary investment in merchandise and may think it unwise to stock the amount recommended by the manufacturer. Finally, if the manufacturer fails, or goes out of business, or if for any other reason the exclusive agent loses or gives up the agency for the product, the time and effort of the dealer in building good will for the exclusive merchandise are lost, and he has difficulty in substituting other products for the ones he has recommended so highly to his clientele. The importance of this depends in large part, of course, on the relation of the volume of business done in the manufacturer's line to the dealer's total business. It would be of only slight importance to a department store to lose the exclusive agency for a brand of women's hosiery, whereas a retailer of automobiles who lost his agency might be forced to abandon his business.

The Concept of Channel Competition.[20] The policy followed by the manufacturer in determining how many middlemen will be utilized in performing the contactual function has considerable influence on the nature of competition. In the case of products with widespread distribution, such as dentifrices, cigarettes, and many food and drug items, the emphasis is on horizontal competition at the various distributive levels. Manufacturers, wholesalers, and retailers do not usually work closely together. Manufacturers compete among themselves to create a demand for their own products. Wholesalers handle the lines of all manufacturers, or at least of a considerable number, and compete among themselves for the retailers' patronage. Retailers are in the same position with respect to consumers. Their principal problem is to obtain business at the expense of other retailers, and they are not greatly concerned as to which manufacturers' products are in demand.

When exclusive or limited agencies exist, however, the nature of competition is much different. The manufacturer, wholesale distributor, and retail dealer will usually work, or attempt to work, in close cooperation with one another to sell the products of the manufacturer. All three have common economic interests, and the welfare of each depends not only upon his own actions but also upon the actions of the other members of the distribution channel. Competition follows a vertical alignment which pits the entire channel for one product against the entire channel for competitive products. Channel competition is an important aspect of the marketing system, but it has not been studied to the extent that competition among individual firms has been and its full significance is not always realized.

[20] See Reavis Cox, "Quantity Limits and the Theory of Economic Opportunity," in Reavis Cox and Wroe Alderson (eds.), *Theory in Marketing* (Homewood, Ill.: Irwin, 1950), pp. 237–40.

DEMAND CREATION

It is difficult perhaps to make a clear-cut distinction as to the point at which the contactual function ends and demand creation begins. Some of the activities of product planning and development are also related to demand creation. For our purposes it does not appear to be necessary to define exact boundaries. All of the functions of selling are closely interwoven, as indeed are all of the functions of marketing. Thus demand creation may be defined as all special efforts to stimulate a desire for goods, with the ultimate objective of sale at a profit. A wide variety of demand-creational efforts have been developed, but the two most important are solicitation by salesmen and solicitation by advertising. Other methods, which are often grouped under the term "sales promotion," are demonstrations, premiums including the use of trading stamps, exhibitions and trade fairs, attractive display, services, and samples. In addition, there is the satisfaction created by the product in use. But all of these must be used in conjunction with personal solicitation or advertising or both.

Personal Solicitation by Salesmen

This was the first method of demand creation to develop and is still the most important and the most widely used. Although exact figures are not available as to the amounts spent on personal solicitation by salesmen, Tosdal has estimated conservatively for the middle fifties a figure of almost $25 billion per year,[21] about two and one half times the amount spent for advertising.

The principal advantages to the use of salesmen are that it is a selective method and that it involves personal contact with the prospective buyer. Salesmen can make a direct appeal to a selected list of prospects, they can make a personal presentation adapted to each prospective purchaser, and they can give information and advice to buyers and gather information for the firm they represent. They can show samples and make demonstrations, services which are particularly useful in the sale of new products. They can often help an indecisive prospect to make up his mind. Sometimes they make deliveries and collections, and they may create good will which is valuable to a firm.

[21] The figure is derived as follows: the cost of outside salesmen—salaries, commissions, and expenses—$12 billion; supervision of outside salesmen (20 per cent of above figure), $2.4 billion; cost of retail selling, $10 billion; total cost, $24.4 billion. Not included are several items such as equipment for salespersons and staff services. See Harry R. Tosdal, *Selling in Our Economy* (Homewood, Ill., Irwin, 1957), pp. 30–1.

Probably the greatest disadvantage in the use of salesmen is the element of expense. Personal calls are expensive, and unless the unit of sale is large, the cost may be prohibitive. Consequently, few large firms rely entirely on salesmen, but they use them in conjunction with other and cheaper means of demand creation. The compensation and expenses of salesmen constitute a large part of the total cost of demand creation, and the effective management of salesmen is of vital importance to most business firms.

Organization of the Sales Force. Figure 18-1 shows a simplified, but common, form of marketing organization used by large manufacturers. The threefold division of territorial management shown in this figure might be found in a large sales organization that sells intensively over a wide territory. A medium-size firm might use an organization in which the salesmen are controlled from branches that report directly to the home office. Many sales organizations, of course, are small, with salesmen reporting directly to the home office, and frequently with no person devoting the major part of his time to their management.[22]

The most common arrangement for the use of salesmen is that in which each one sells all of the company's products in a particular geographical area. A particular company's lines, however, may be so wide or its products may be so varied that its sales force is divided into special groups, each selling only one or several products of the complete line. One manufacturer of industrial goods, for example, has nine separate sales departments, each with its own salesmen. One sells diesel motors, one sells air conditioning equipment, another sells scales, and so on. In other cases, although the products are similar, it is necessary to specialize in selling to particular classes of customers in order to obtain the best results. A public utility company desiring to increase its sale of gas and gas equipment for heating had special men selling to homes, others selling to apartment houses and hotels, and several others who were specialists in selling to different types of industrial prospects. Such specialization by products or by classes of customers results in more than one salesman covering a particular geographical area and adds to the total selling cost. It can be justified only when the increase in total sales is great enough to offset the additional cost. Many companies combine two or three of these methods. They may, for example, have territorial salesmen who sell all of the company's products to all classes of buyers in some areas, and other salesmen who specialize on particular products or particular classes of customers only where there is an adequate concentration of buying power to warrant the additional expense that results from their use.

[22] For a discussion of sales organizations and recent changes in them, complete with numerous illustrative diagrams, see Henry Bund and James W. Carroll, "The Changing Role of the Marketing Function," *Journal of Marketing*, January 1957, pp. 300–25.

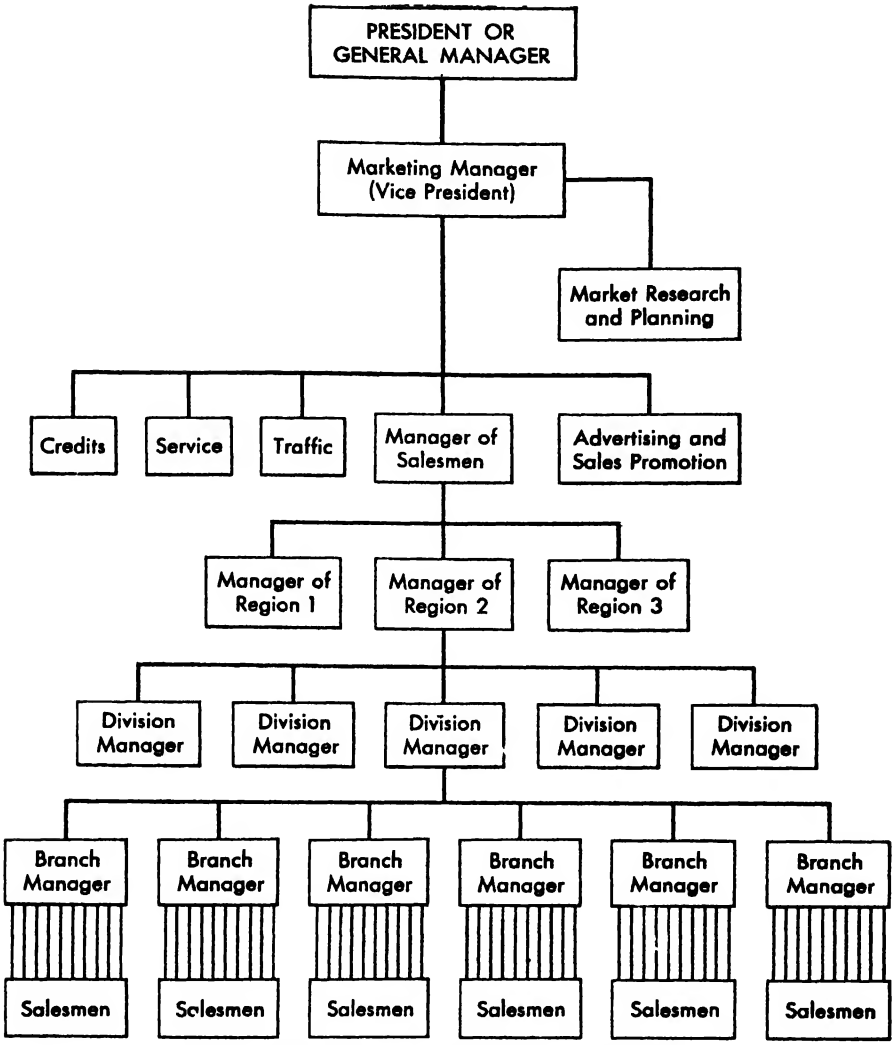

Figure 18-1. Marketing Organization Chart.

Advertising

Advertising may be defined as "any paid form of non-personal presentation and promotion of ideas, goods, or services by an identified sponsor." [23] Demand creation through advertising involves the use of the written, printed, or spoken word, pictures, diagrams, and symbols. The amount spent for advertising in 1959 was estimated by *Printers' Ink* at $11.1 billion.[24] This includes

[23] *Marketing Definitions, op.cit.*, p. 9.
[24] *Printers' Ink*, August 12, 1960, p. 11.

the cost of time and space, talent, production, and all other items charged to an advertiser's budget by media. Approximately 60 per cent of the total was spent by national advertisers, the balance by local advertisers.

The chief advantages of advertising arise from its character as a mass medium of communication and from its capacity for repetition. A single advertisement may reach large numbers of people at relatively low cost and, in contrast to a single infrequent call by a salesman, advertising may bring an article to the attention of a prospective buyer repeatedly and at short intervals. It may be used to spread information over wider areas, and it may reach and create demand among individuals who would not be considered good prospects for salesmen. Its chief disadvantages are that it is impersonal and easily ignored, it cannot answer questions unless they have been anticipated and the necessary information is included, and it is usually therefore less effective than is personal salesmanship.

Although less money is spent in total for advertising than for personal selling, advertising is an important element in the sales program of many businesses, especially those involved in the marketing of consumer goods. It is seldom used as the sole method of demand creation but rather as an important complement to personal selling. It often serves the purpose of creating a favorable impression regarding the product and thus makes buyers more receptive to the personal selling effort. Many firms also engage in institutional advertising, rather than the advertising of specific products, to create a company image and maintain their identification and status in economic society.

The Advertising Agency. Although most business firms that spend an appreciable amount of money for advertising maintain their own advertising departments to plan and supervise expenditures, the specialized knowledge required for effective advertising has led to the development of the advertising agency. While originally acting as space brokers for periodicals, advertising agencies now serve national advertisers by preparing their advertising. They are familiar with advertising methods and media and so are able to provide counsel on advertising policies, prepare advertisements, and buy space and time for their clients. The complete service of a modern advertising agency also provides facilities for product and marketing research, radio and television production, counsel on general marketing problems, and even for planning the complete selling campaign. When an agency provides a complete service of this kind, it can render more effective service for its clients and carry out more effective advertising campaigns.

Because advertising agencies originally represented publications, they were given a commission—traditionally 15 per cent—for the sale of space. They now represent the advertisers, but the media have retained the system of

paying commissions on space sold through the agencies. This has been done by general agreement, on the principle that the agencies make advertising more effective and thereby stimulate the growth of the advertising business. But as agencies have come to offer more complete service to the advertiser, the practice of charging fees in addition to their commissions on publication space and radio and television time has developed. Thus fees are frequently charged the client for conducting extensive research operations and for producing radio and television programs. But large advertisers may be given such services without charge, because the commissions to the agency for the space they use are so large that they can demand free service.

Recently there has been considerable controversy regarding the 15 per cent commission to the agency, a commission that is not available to the advertiser who bypasses the agency and places his advertising directly with the media. In 1955 the United States Department of Justice brought action against several publishers' associations and the American Association of Advertising Agencies, charging that the maintenance of the 15 per cent commission by general agreement constituted a violation of the antitrust laws. The defendants, in the settlement of the case in 1956, cancelled the general agreement, but individual media are still granting the 15 per cent commission. Some national advertisers would prefer to eliminate the commission and have the charge for space and time reduced by that amount. This would give the advertiser greater freedom of choice in deciding whether, and to what extent, he might employ the services of an agency.[25]

Other Methods of Demand Creation

Although personal selling and advertising represent the basic methods of demand creation, there are many other ways by which sellers attempt to stimulate sales. In some lines, manufacturers *display* their products at trade fairs and exhibitions or establish show rooms in attractive surroundings where buyers may come to examine the merchandise. Retail stores place a great deal of emphasis on attractive window and counter display to create an initial interest in the merchandise. The growth of supermarkets and self-service in retailing has led more and more to the creation of demand through the mass display of the products offered for sale. Stores of this type render a minimum of service to the customer. Other firms attempt to create demand

[25] For a comprehensive report on this and other aspects of agency-client relationships, see Albert W. Frey and Kenneth R. Davis, *The Advertising Industry: Agency Services, Working Relationships, Compensation Methods* (New York: Association of National Advertisers, 1958).

through the offering of extensive *services* in connection with the sale: delivery, credit, and many others.

The distribution of free *samples* of a product, either through retail stores or directly to the home, is another method of demand creation that has been used frequently. Similar to this is the distribution of *coupons* to householders by manufacturers. These coupons are worth a certain amount of money when applied to the purchase of a specified product at any retail store. Samples and coupons are most commonly used in connection with food and household products.

Premiums constitute another method of demand creation, of which a special form is the use of trading stamps. In recent years, trading stamps have become a big business and subject of much controversy. Trading stamps are purchased by retailers from a stamp company and given to customers of the retailer in proportion to their purchases. The consumer accumulates stamps until he has a sufficient quantity to obtain a desired merchandise premium, at which time he presents them for redemption to the stamp company. Trading stamps appear to be an effective demand-creational device for some retailers, under certain conditions and if properly promoted.[26]

A final method of demand creation is the *satisfaction* obtained by the purchaser *in the use of the article*. The continued sale of most commodities depends upon this satisfaction. A large proportion of everyday purchases are made because a product has proved satisfactory to the purchaser or to his friends. If a consumer has tried a product and finds it satisfactory, he is likely to buy it the next time he needs an article of the same kind. If his friends like it, he is prone to try it himself.[27] Satisfactory products in actual use constitute the final test of the effectiveness with which the selling function is performed.

THE MARKETING MIX

The marketing objective of a seller is to combine the various sales-producing elements in such a way that he will achieve the necessary volume of sales at a cost that will permit him to make a desired profit. These sales-producing elements may be designated as "the marketing mix," and they include the product, the brand, the package, personal selling, advertising,

[26] See Albert Haring and Wallace O. Yoder (eds.), *Trading Stamp Practice and Pricing Policy*, Indiana Business Report No. 27 (Bloomington: Bureau of Business Research, Indiana University, 1958); Eugene R. Beem, "Who Profits from Trading Stamps?" *Harvard Business Review*, November–December 1957, pp. 123–36; and Harvey L. Vredenburg, *Trading Stamps* (Bloomington: Bureau of Business Research, Indiana University, 1956).

[27] See, for example, Robert C. Brooks, Jr., " 'Word-of-Mouth' Advertising in Selling New Products," *Journal of Marketing*, October 1957, pp. 154–61.

and the other demand-creational activities specified above, as well as the price and the channels of distribution.[28] Most of these elements have been designated here as phases of the selling function and the others are obviously closely allied.

The problem of the seller is how to combine these various elements of marketing strategy. Shall he spend large sums of money to develop new products or spend this money to promote the sale of existing products? If higher margins are given to middlemen, will the manufacturer be able to reduce his own expenditures for demand-creational activities? If the price of the product is established below the market level, will the seller be able to reduce his expenditure for personal selling? How much effort should be devoted to packaging in comparison with advertising? What proportion of demand-creational expenditures should be made for personal selling, for advertising, and for other methods?

These are illustrative of the types of decisions that must be made by marketing management. These various elements of selling tend to be used jointly. Each firm must try to find the best combination for its particular situation at a particular time. Moreover the decisions are not easily made. In many instances it is difficult to obtain information upon which to base a decision. There are so many alternative mixes available that it is difficult to run elaborate experiments that will measure the results of various combinations. Furthermore, costs change, competition changes, and consumer tastes change, making it necessary to vary the mix from time to time.

Nevertheless, decisions are made with respect to the marketing mix. New products are created and changes are made in existing products. Packages are redesigned from time to time. Price and channel policies are established. Determinations are made with respect to the allocation of expenditures for personal selling and advertising. These are largely decisions made by the individual firm for its own situation. They do not necessarily have general applicability, although we do know, for example, that industrial goods manufacturers tend to spend proportionally less for advertising than do consumer goods manufacturers.[29] On the other hand, we also know that competing companies in the same industry usually utilize different mixes.

Marketing students and economists have not been too helpful in providing guides to the solution of the problem of the marketing mix. Such study

[28] See Albert W. Frey, *How Many Dollars for Advertising* (New York: Ronald, 1955).

[29] One recent survey indicates that the median expenditure for advertising by consumer goods manufacturers was 3 per cent of sales compared with 0.8 per cent for industrial goods firms. See Dale Houghton, "Marketing Costs: What Ratio to Sales?" *Printers' Ink*, February 1, 1957, pp. 23 ff. A study by Edwin H. Lewis in 1954 compares advertising and personal selling expenditures for 38 manufacturers. For results, see John A. Howard, *Marketing Management: Analysis and Decision* (Homewood, Ill.: Irwin, 1957), p. 324.

as they have devoted to the subject has been concerned primarily with the determination of advertising expenditures, possibly because business executives appear to be less satisfied with their decisions regarding advertising than with those regarding other elements of the mix. On the other hand, one writer states that decisions as to the personal selling appropriation are made almost entirely on an intuitive basis.[80] We need more study of the marketing mix to determine whether principles can be established for the guidance of marketing managers.[81]

EVALUATION OF THE SELLING FUNCTION [82]

It is evident from the foregoing discussion that the selling function involves many marketing activities and that large sums of money are spent in attempts to sell goods. A considerable amount of criticism has been directed at modern large-scale selling efforts. Actually, most of this criticism has been concerned with advertising rather than with personal selling or with product planning and development. The reason for this appears to be that advertising, being aimed at the mass market and containing a considerable amount of repetition, is a more pervasive phenomenon than are some of the other selling activities. As noted above, advertising is not necessarily the most important, and certainly not the most expensive, of the various methods used in selling. It is in fact customarily utilized to reduce the total cost of selling in relation to what it would be if advertising were not used. Accordingly, the criticisms directed at advertising will be considered here as being equally applicable to all large-scale selling methods, and it is to be understood that the latter are included in the general discussion.

Criticisms of Large-Scale Selling Methods

It is alleged that modern selling methods do not give the consumer adequate buying information and that they influence him to buy the wrong products, sometimes through the use of false and misleading statements. That this criticism has some validity cannot be denied. That false and mis-

[80] John A. Howard, *op.cit.*, p. 352.

[81] For suggestions regarding possible approaches to this problem, see Albert W. Frey, *op.cit.*, Chap. 4, and John A. Howard, *op.cit.*, Chaps. 13 and 14. For a theoretical approach to the entire problem of determining the marketing mix, see P. J. Verdoorn, "Marketing from the Producer's Point of View," *Journal of Marketing*, January 1956, pp. 221–35. For a suggested formula to determine the optimum number of salesmen, see Walter J. Semlow, "How Many Salesmen Do You Need?" *Harvard Business Review*, May–June 1959, pp. 126–32.

[82] For an excellent and complete discussion of this subject, see Harry R. Tosdal, *op.cit.*, esp. Chaps. 8–10.

leading advertising is a problem, for example, is recognized by the fact that there is federal legislation prohibiting it, legislation that will be discussed in a later chapter. Nevertheless, a great deal of accurate buying information is made available to the consumer through advertising and personal selling, and the consumer apparently finds it helpful in making choices that are satisfactory to him. If this were not true, it seems likely that some products with large selling budgets would no longer be available in the market.

It is also alleged that selling costs are too high and that there is waste in the use of resources. There is little question that selling costs in some lines have become excessive and wasteful. But in a competitive society, and in any other type of society for that matter, some waste is inevitable. Moreover, as has been pointed out previously, the seller does not have sufficient information by which to determine the optimum combination of the elements involved in the selling mix. Errors in judgment inevitably will be made, resulting in higher selling costs than necessary to accomplish the desired result. But this is not sufficient to indict large-scale selling methods. The principal question to be answered is whether the sums spent for selling in an enterprise economy result in a better product for the consumer at a lower price than would otherwise be the case.

Large-Scale Selling and Costs

In a modern industrial economy, effective selling effort goes hand in hand with large-scale production. It enables manufacturers to sell their output, to maintain and increase their scale of operation, and thereby to achieve manufacturing economies. Thus the price of the product can be reduced to the consumer despite the fact that selling costs are higher than they would be in a less developed economy. That the economies of modern large-scale, mechanized production have more than offset the increased cost of selling that has been necessary to market factory-made products is indicated by the fact that per capita production has increased. In other words, the *total* cost of making and selling most products has tended to decline as markets have expanded. Increased marketing costs, including selling, have been more than offset by decreased production costs.

This, in the final analysis, is the basic social justification for the selling function. Although it is difficult to make direct comparisons, because of the changes that take place both in products and in price levels, there can be little doubt that the modern consumer obtains better products at a lower real cost than did his counterpart of an earlier era. Obviously there are some exceptions, cases in which selling efforts result principally in increasing the costs of competition without increasing the total market for the product. In

these instances, a higher price for the product tends to be the result, and may be regarded as a cost of our enterprise system. On balance, however, we may conclude that selling is a necessary and worthwhile function and that the large sums of money devoted to it have brought consumers more and better products at a lower total cost than would have been possible otherwise.

QUESTIONS FOR DISCUSSION

1. Phillip McVey in the article cited in the bibliography takes exception to the idea that a channel of distribution is an integrated or organized business entity controlled by the manufacturer. He states that the businessman is more likely to deal only with the suppliers and customers immediately adjacent to him rather than with all of the links in the channel and that the manufacturer "may little know or care what becomes of his products after they leave the hands of some merchant middleman who has paid him for them. . . ." Compare this point of view with the concept of channel competition of Reavis Cox, as mentioned in this chapter, and indicate and illustrate the conditions under which each may be correct.
2. The cost to a retailer of giving trading stamps is about 2 per cent of his sales volume providing that he gives them with every purchase. An article in the August 1960 issue of *Fortune* states that trading stamps are given with about 40 per cent of all grocery store sales and with 15 per cent of all retail sales. It is further stated that 75 per cent of all American families now save trading stamps and that there are 250 stamp companies in the United States.

   Assume that you are a retailer in a state which has had a restrictive law with respect to trading stamps but that this law has just been repealed. You are approached by the leading stamp company with a proposal to handle its stamps. Would you do so if you were (a) the leading department store of the city, (b) a large independent supermarket, (c) a medium-size gasoline service station? Why or why not?
3. Why does each of the following products tend to be sold through limited or exclusive agencies: (a) gasoline, (b) electrical appliances, (c) automobiles, (d) high quality men's suits, (e) paint?

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19. BUYING

In every marketing transaction, there must be a buyer as well as a seller. Despite the fact that the seller usually takes the initiative in the negotiations leading up to the final transaction, there are many marketing activities that must be performed by the buyer. These activities were grouped in Chapter 1 into the following subfunctions: (1) planning assortments, (2) the contactual, (3) assembling, (4) negotiation, and (5) the contractual. As in the case of the discussion of the selling function, the negotiatory and the contractual functions will not be treated in detail.

In order to show how various types of buyers perform the buying function, it is necessary to classify them into somewhat homogeneous groups. First, there are the manufacturers and other business buyers who purchase raw materials, supplies, parts, and equipment for use in their own operations. Secondly, there are the middlemen, wholesalers and retailers, who buy merchandise for resale. Finally, there is the ultimate consumer who buys for his own use. The buying problems of the ultimate consumer were discussed in Chapter 7 and will be referred to here only when they are particularly pertinent to the discussion. We shall be concerned primarily, therefore, with the performance of the various buying functions by manufacturers buying goods for their own use and middlemen buying for resale.

PLANNING ASSORTMENTS

In a modern economy, the average consumer expects to be able to buy what he wants when he wants it. He is generally able to do so because of the planning activities of manufacturers and middlemen. The essence of planning is judgment. What products will consumers need? In what qualities and quantities? How rapidly will they be consumed? Finding the answers to these questions constitutes the basis of the planning function for the

buyer. Most commodities are available on short notice because of the activities of a large number of specialists who make it their business to judge in advance what the nature and volume of demand will be and who produce or purchase the goods far enough in advance of final demand to have them ready for use.

Budgeting

Although businessmen approach the planning function in various ways, the use of a budget is recommended. In fact, a budget, which is simply an over-all plan for operations, is essential to the efficient performance of the buying function. The budget, for either the manufacturer or the middleman, starts with a forecast of the probable sales volume to be attained during a specified future period of time. From this information the manufacturer can determine the necessary rate of production, and the middleman can determine the amount of stock that he must carry, to achieve this expected sales volume. Finally, the over-all purchasing budget is established.

Determining Order Quantities. Various devices may be used to fill in the details of the purchasing budget, i.e., to determine the exact quantity to order of each size, color, type, or item. The manufacturer makes lists of supplies and materials necessary to maintain his production schedule. He then compares the prices that may be obtained by ordering larger quantities with those charged for smaller orders, takes into account the costs of carrying the larger quantities in stock, and determines the most economical amount to order.

Middlemen use similar procedures. For convenience goods, a basic stock list may be maintained. This lists each item to be carried in stock, indicates the minimum amount desired, and specifies the reorder quantity. An analysis of past sales records is necessary to determine the proper information for the basic stock list. Of particular importance is information regarding the rate of sale of the various items. Moreover, basic stock lists must be revised as rates of sale change and as items are added to or dropped from stock.

For fashion merchandise, a model stock plan may be utilized. This specifies the assortment of merchandise that should be carried according to size, color, price line, and style. It is derived in part from past sales and in part from forecasts of expected demand and serves as the basic buying plan for the particular type of merchandise. It is often used in conjunction with a perpetual inventory system which shows daily sales by color and style.[1]

[1] For more detailed discussions of basic stock lists and model stock plans, see Delbert J. Duncan and Charles F. Phillips, *Retailing: Principles and Methods*, 5th ed. (Homewood, Ill.: Irwin, 1959), pp. 248–56.

Stock Turnover. A proper rate of stock turnover is an important and desired result of good management. It does not depend alone upon efficient buying, since proper pricing and effective selling are also necessary, but the accurate determination of order quantities is an important element in arriving at the desired rate of stock turnover. Stock, or merchandise, turnover can be defined as the number of times the average inventory of stock is sold (and replaced) during a certain period, usually one year. It may be computed by dividing the cost of goods sold by the average inventory at cost, or by dividing the net sales by the average inventory at selling prices. Thus, in the first method, if the cost of goods sold is $200,000 and the average inventory at cost is $25,000, then $200,000 divided by $25,000 gives a turnover of eight times. To illustrate the second method, assume that net sales are $300,000 and the average inventory at selling price is $37,500. Dividing $300,000 by $37,500 gives the same rate, eight.

There are specific advantages which accrue from a rapid turnover. It is a governing principle of sound merchandising that only so much capital should be tied up in stocks as is necessary to furnish adequate service to the firm's customers. With a rapid turnover, the investment necessary to do a given volume of business is reduced. There is likewise a saving of interest on the investment in stock when the inventory is small, and insurance and personal property taxes are less. The risks and losses of carrying a large inventory are reduced since there is less danger of physical deterioration, a smaller number of goods will be left to dispose of at marked-down prices at the end of a season or following fashion changes, and shelf-worn goods will be less in evidence. Stocks are more likely to be fresh and up to date, they will occupy less storage space, and the cost of handling them will be reduced.

Although a high rate of turnover is very desirable, there are certain hazards which lie in efforts to obtain too fast a rate. Merchandise is likely to be reduced in amount and variety until a loss in sales takes place or, where larger stocks are maintained and low markups are used to increase the rapidity of turnover, it often happens that profit margins are inadequate to cover expense requirements. Then, too, buying in small amounts, when carried to extremes, frequently brings about an increase in the unit cost of merchandise and in buying and selling expenses, which largely offsets the savings realized through speeding up the rate of turnover.

The Problem of Fashion

In planning assortments, even for convenience goods, it is never easy to keep up with changing consumer tastes. For fashion merchandise, it is a

particularly difficult problem and one which must be constantly studied by the manufacturer and middleman. Fashion has been defined "as a conception of what is currently appropriate." [2] It differs from a style in that the latter is a permanent thing, in the classic words of Paul Nystrom, "a characteristic or distinctive mode or method of expression, presentation, or conception in the field of some art." [3] A fashion is a style that is in demand, that has gained some popular use. So long as it is more or less widely accepted it remains a fashion, but sooner or later it is replaced by another fashion.

Fashion change is usually considered to be an evolutionary process, and general changes in consumer demand often are brought about slowly and gradually. But particular manifestations of fashion, for example, color preferences, often change very quickly. Moreover, fashions which have been in existence for a long time and which have developed excessive versions generally die suddenly and arbitrarily.[4] The pattern of fashion change has been described in terms of a three-stage cycle.[5] The first stage is the period of distinctiveness when the particular style is being purchased and used by a relatively few people who desire something unusual. During the second period, that of emulation, the style gains wider acceptance. During the third stage, economy in emulation, the style is sold in large quantities and at low prices. In a modern economy with rapid communication and the widespread dissemination of fashion information, it is difficult to distinguish these three stages of the fashion cycle. Almost everyone wants the same thing at the same time and the cycle has been described as a blur rather than a distinguishable phenomenon.[6]

It is thus evident that the retailer of fashion merchandise has a particularly difficult buying problem. He must anticipate fashion trends in such a way that he will stock the proper merchandise at the beginning of a selling season, will have adequate stocks on hand throughout the period of popularity of a style, but will not be overstocked when fashion changes to a new style. Fashion information and opinions are available, of course, from many sources: trade papers and fashion magazines, fashion advisory services, buying offices in fashion centers, and manufacturers and other sources of supply. Market trends in the leading fashion centers must be studied, and competitive stores in a retailer's own market area are often shopped for fashion infor-

[2] Alfred H. Daniels, "Fashion Merchandising," *Harvard Business Review*, May 1951, p. 51.

[3] Paul H. Nystrom, *Economics of Fashion* (New York: Ronald, 1928), p. 3.

[4] For an interesting discussion of this point with numerous examples, see Dwight E. Robinson, "Fashion Theory and Product Design," *Harvard Business Review*, November–December 1958, pp. 126–38.

[5] Melvin T. Copeland, *Principles of Merchandising* (Chicago: Shaw, 1924), pp. 163–7.

[6] Alfred H. Daniels, *op.cit.*, p. 52.

mation. In addition, it is essential that close watch be kept of exactly which items, colors, and designs are selling well, and most retailers of fashion goods keep perpetual inventory records on which unit sales are recorded daily. Those items and colors which sell rapidly are reordered while slow sellers are marked down for quick disposal and are not reordered. In fashion merchandise timing is very important, and it is often desirable for a retailer to stop reordering a fashion at the time that it appears to be at its peak of popularity. By doing so, assuming his judgment is correct, he will exhaust his stock of the item in an orderly manner as its popularity declines.

Despite the problems involved, there is nothing mysterious about fashion merchandising. All buying is concerned primarily with three questions: what, how much, and when. The answers to these questions for fashion merchandise are somewhat more difficult to obtain than they are for other goods. But successful buyers of fashion items do not necessarily have a "flair for fashion" or any sixth sense which enables them miraculously to forecast consumer demand. They rely on careful study of all available fashion information—on facts rather than on intuition. In this connection, the use of unit sales records is of considerable importance. This is illustrated by the successful buyer who operated entirely from unit control cards and claimed to have no knowledge whatsoever of what the dresses in his stock looked like. Such a procedure is not necessarily recommended, but it does indicate that an analytical and factual approach to fashion buying is essential.

Effect of Price Changes on Buying Plans

The objective of the typical buyer, whether manufacturer or middleman, is to follow a buying plan that will result in balanced assortments and inventories in relation to anticipated sales and needs. Orders are placed at regular intervals for such quantities as are necessary to maintain adequate stocks for manufacture or for resale, in the light of economical order quantities, the costs of carrying the goods in stock, and the desired rate of stock turnover. This type of buying plan, by its very nature, must be predicated in most instances upon the assumption of a stable, or almost stable, price level. When prices are changing rapidly, or are expected to change, a new element is injected into the buyer's planning, whether to accumulate stocks of goods or whether to permit them to fall to lower-than-normal levels.

Hand-to-Mouth Buying. If prices are declining, the buyer will usually reduce order quantities, order more frequently, and maintain stocks at the minimum level necessary for current operations. Such a policy is termed "hand-to-mouth buying." It is followed because the buyer desires to mini-

mize the possibility of inventory losses. He is willing temporarily to sacrifice the quantity discounts available on larger orders and to risk the possibility of losing some sales because goods are out of stock. The possible losses that may result from a decline in inventory values are often sufficient to threaten the very existence of a business. By comparison, the higher costs involved in hand-to-mouth buying may be quite insignificant.

Forward Buying. When prices are rising, or if it is anticipated that commodities will be in short supply or deliveries uncertain because of strikes or for other reasons, the buyer may tend to follow a policy exactly opposite to the one just described. He increases order quantities, buying more than is needed for current operations, and accumulates inventories. This policy is known as "forward buying." If such a policy is followed, it is because the buyer expects to more than offset the higher costs of carrying the additional stocks by monetary gains obtained through the appreciation of inventory values. Also, many firms find it necessary at times to follow a policy of forward buying in order to assure themselves of stocks. But a great deal of caution must be used. After a sustained rise in prices has taken place and the time appears most propitious for forward buying, it is often the case that prices have attained, or nearly attained, their peak. The subsequent decline leaves the forward buyer with high-cost inventories that either must be sold at a loss or used to produce goods the selling price of which will not cover total costs, including the high cost of the materials. In addition, the buyer has incurred the added costs of carrying the greater amount of stock.

An extreme form of forward buying is known as "speculative buying." Here the buyer purchases in quantities considerably larger than would appear to be needed during the foreseeable future, often with the idea of reselling in the general market rather than to his normal clientele. Such a policy definitely should not be followed by the buyer who is in business for the purpose of making a normal profit from manufacturing or marketing operations. The risk is very great and, if the speculation is not successful, the continued existence of the business may be seriously threatened.[7]

THE CONTACTUAL FUNCTION

From the standpoint of the buyer, the contactual function involves searching for sources of supply and maintaining contacts with them. Although we tend to think of the seller as the one taking the initiative in making contacts,

[7] For an evaluation of forward buying and speculative buying, including a discussion of the question of when is hand-to-mouth buying speculative, see Howard T. Lewis and W. B. England, *Procurement: Principles and Cases*, 3rd ed. (Homewood, Ill.: Irwin, 1957), Chap. 11.

there are many instances in which the buyer actually makes the initial contact. This is, of course, particularly true of the ultimate consumer buying at the retail level. The initial contact is usually made when the consumer enters the retailer's place of business. Although many retail businesses, for example, those engaged in selling household appliances and automobiles, maintain outside sales forces for the purpose of making contacts with prospective buyers, it is evident that for most of our retail transactions the initial contact is made by the buyer.

Even in buying transactions involving businessmen rather than the ultimate consumer, many of the initial contacts are made by buyers rather than sellers. The buyer of clothing for a retail store generally visits the New York market at least twice a year to look over the merchandise offerings of vendors. Furniture buyers may make trips to several national and regional markets. In these instances, the initial contact often comes largely from the buyer. Manufacturers buying supplies, materials, and equipment may also initiate the contactual function, especially with respect to items purchased infrequently and during times when important materials are in short supply. In the latter instance, buyers may be particularly aggressive in searching for sources of supply. Even under normal purchase conditions, particular products may be so important to the success of the manufacturer who buys them—in the production of uniform goods, in the improvement of processes and products, and in the reduction of costs—that he does not wait to be influenced, but takes the initiative in searching out new raw materials, new equipment, or new supplies.

Concentration of Purchases

One of the buying problems faced by business buyers is the extent to which they shall concentrate purchases, and thus contacts, with a single source, or a very few sources, of supply in contrast with the utilization of a number of sources of supply. There is no very satisfactory answer to this question.

Concentrating purchases with a few suppliers usually reduces the cost of performing the contactual function, establishes continuing relationships with a small number of suppliers, and thus may result in better service. Large orders placed with a few suppliers may result in obtaining quantity discounts and lower prices that could not be obtained with small orders spread over a larger number of suppliers.

On the other hand, the concentration of purchases involves some disadvantages. The inability of a key supplier to meet his commitments, as a

result of a natural disaster affecting his plant, e.g., fire or flood, or because of a strike, may leave the buyer without vital materials and supplies. Competition among sellers, who know that the buyer is not committed to a single source of supply, may bring better service and lower prices. In general, the diversification of purchases tends to give the buyer more flexibility than he might have otherwise.

Most buyers tend to follow a middle policy. They utilize more than one source of supply so that they will not be entirely dependent upon a single vendor. However, they do not follow a policy of complete diversification, preferring to concentrate purchases with a few sources rather than utilize many. In this way, buyers achieve most of the advantages of concentration and still maintain much of the flexibility of diversification. There are, of course, many exceptions, particularly with respect to buying by middlemen. Some follow policies of complete concentration, as does the contract chain retailer who purchases all dry groceries from the same wholesaler. Others often follow policies of extreme diversification, the natural function of a middleman being to handle the products of many manufacturers.

Reciprocal Buying

In general, reciprocal buying involves the purchase of goods from a supplier who is expected in turn to buy from the customer. Thus a simple form of reciprocity might involve a railroad which buys its rails from a steel company that regularly uses the facilities of the railroad. Slightly more complicated is the situation of the railroad which has as customers several steel companies and which accordingly allocates its orders for rails among those firms in proportion to their patronage of the railroad. Still more complex is the situation of the railroad which orders hopper cars from a manufacturer of railway equipment and instructs that manufacturer to allocate his orders for steel among certain companies in designated proportions, proportions that presumably reflect the patronage of the railroad by the various steel producers.[8] It is evident that reciprocity can be a complex problem, more so for manufacturers than for middlemen, and that it has a substantial effect upon the performance of the contactual function.

It may be presumed that few people would defend the practice of reciprocity when it results in substantially higher prices or definitely poorer service. It probably also may be presumed that a majority of businessmen would see no harm in it so long as prices, quality, and service were at least as favorable as could be obtained from competitive sellers. There can be little doubt that

[8] An actual situation described in Lewis and England, *op.cit.*, p. 415.

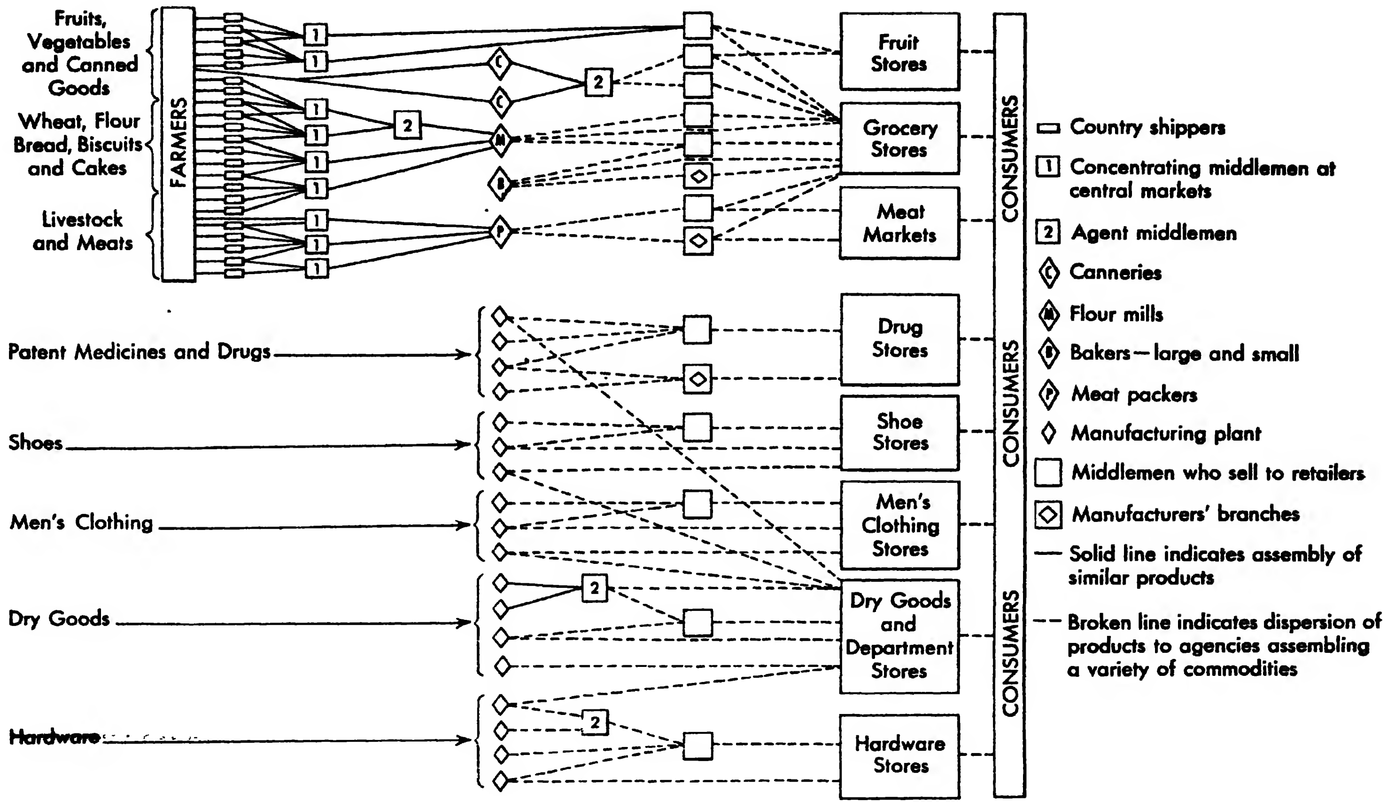

Figure 19-1. Assembly of Consumer Goods.

reciprocity is a widely used policy under these latter conditions. There is also evidence that it is used to some extent even when the result is the payment of higher prices for the purchased items.[9] That reciprocal relations limit the field in which buying is done and tend to limit the alertness of the sales force of the selling organization is evident. Moreover, the firm that engages in reciprocal relations with one supplier is likely to have pressure brought to bear by many other suppliers seeking the same privilege. The result is likely to be that exchanges are made on a bargaining basis, and often on unfavorable terms, rather than on the merits of products and services. In view of these obvious disadvantages, careful consideration should be given to the practice in any specific situation to be certain that the gains are greater than the losses.

ASSEMBLING

There are two phases of the assembling function. One is the process of concentrating small quantities of like goods from individual producers into larger lots which are necessary for economical transportation, storage, grading, and sale, for the economical processing of raw materials, and for economical wholesale distribution of agricultural products consumed in their natural state. This phase of assembling is the process of concentration of individual products discussed in Chapter 1.

The second phase of assembling is that which brings together at consuming and distributing points—factory, wholesale house, retail store—the variety of products needed at those points to meet the desires of producers, middlemen, and final consumers. Both types of assembling are shown in Figure 19-1.

Assembling Industrial Goods

Middlemen are the chief assembling agencies for consumer goods and also render an important service in assembling products to be used in manufacturing plants and by other business enterprises. But the assembling of products for use in manufacture must be completed by the manufacturing organization, whether it buys from middlemen or directly from the producers of the products that are used. The raw materials, the semimanufactured and completed parts that are used to make the finished product, as well as the machinery, equipment, and supplies used in manufacturing and selling operations, must be assembled at the plant. In this way products are assembled indirectly for those who later buy the finished product. The automobile is

[9] *Ibid.*, pp. 415–6.

an assembled product in this sense, as well as in the manufacturing sense. Even those manufacturers of automobiles who make most of their own parts assemble some parts, and perhaps many of the accessories and equipment. Tires, speedometers, lighting systems, bodies, windshields, wheels, axles, springs —some or all of these are bought ready to install even by the largest manufacturers. Furthermore, the production of most of these parts likewise necessitates the purchase of equipment, supplies, raw materials, and semimanufactured products.

Assembling by manufacturers may also be more direct. For example, some producers of a particular part of a line of goods purchase or handle on consignment, or purchase for resale, the related products of other manufacturers. In this manner they are enabled to handle a "full line" of products with the advantages in selling which a complete line sometimes carries with it.[10] Moreover, their overhead expenses may thus be spread over a greater volume of sales. Lumber manufacturers who own their own retail yards usually handle other building materials; tool manufacturers and manufacturers of machinery frequently handle related but noncompeting products made by other firms.

Sometimes the manufacturer's own purchasing department searches out the sources of the materials needed. This is particularly true of large establishments and of those which have difficulty in finding the particular kind of raw material they need. But many manufacturers depend upon middlemen to do this work for them. Few, if any, buy all their materials, supplies, and equipment directly from producers.

Assembling Consumer Goods

The final process of assembling is, of course, that in which the consumer brings together the assortment of items he desires to consume. But back of him there may have been a long line of assemblers—retailers, wholesalers, agent middlemen, manufacturers. Looked at from the point of view of the consumer the work of all these, as well as of the agencies preceding the manufacturer, is to assemble and prepare commodities for final consumption. The consumer looks chiefly to the retailer for these commodities, and the main function of the retailer is to assemble them for him. But the retailer, in turn, looks to the manufacturer and to wholesale middlemen for the goods he handles. They assemble for him. The regular wholesaler in particular plays an important part in this process. The grocery wholesaler, for example, and the wholesale department of a chain grocery system, assemble hundreds of varieties and brands of goods which come from all parts of the world, and

[10] Wholesale and retail dealers often increase their lines for these same reasons.

make them available to the retail store, from which they are finally assembled by the ultimate consumer.

ORGANIZING FOR BUYING

From the foregoing discussion, it is evident that buying is an important and complex function, the effective performance of which may well be vital to the success of a business enterprise. It is desirable, therefore, to consider briefly the types of organization used by manufacturers and middlemen in their efforts to establish effective control over the buying function.

By Manufacturers

In manufacturing concerns, it is common practice to have the buying function organized under a specialized department with a purchasing agent in charge. Moreover, when individual purchases involve large expenditures at a given time or over a period of time, or when technical considerations are particularly important, products and prices are likely to be passed on by a number of members of the organization outside of the purchasing department. These range from workmen who use the products to foremen, factory superintendents, industrial research personnel, consulting engineers, architects, contractors, and often to higher officials and even the board of directors. The more important the article is to the success of production and the larger the amount invested, the higher will be the officials who may exercise an influence on its purchase. The seller may find, consequently, that although it is relatively easy to locate individual establishments that are prospects and to determine the nature and amount of their needs, as compared with the mass selling methods used to influence consumer prospects, it is not always easy to determine those within the establishment who influence the sale or whose decision will result in a purchase.

By Middlemen

Among middlemen by contrast, location of the person with authority to buy is likely to be somewhat easier. Most retailers and wholesalers of any size specialize their buyers by product lines or product departments. One person is designated as the buyer for each of these departments, and he has the general authority to buy all merchandise handled by that particular department. He is subject, of course, to the general supervision and control of a merchandise manager or general manager, but with respect to decisions

regarding specific items, the departmental buyer usually has a considerable degree of autonomy.

Resident Buyers. Retailers and wholesalers sometimes utilize the services of permanent representatives in large markets. These representatives are commonly called "resident buyers" in the dry goods and clothing trades, and "purchasing agents" in the hardware trade. Some serve a single large department store or chain organization, form a regular part of the retail organization they represent, and are maintained by it. Others are independent middlemen who develop business relationships with individual stores or groups of stores. Sometimes they represent several stores which operate on a co-operative basis in making purchases through the resident buyer; and sometimes, although representing a large number of stores, they maintain entirely separate relationships with each store. Most department stores, large specialty shops, chain stores, and men's furnishings stores use the services of such representatives in the larger cities of the country, particularly in New York and Chicago.[11] In the hardware trade wholesalers frequently use their services, although retailers are also represented at times.

The resident buyer has a continuing relationship with the firms he serves. His chief function is to furnish buying advice and assistance to his clients. This includes current market information concerning fashions, new products, price trends, and desirable sources of supply. He commonly assists his customers' buyers when they visit the market, and provides them with a headquarters and the necessary facilities for carrying on their purchasing. He frequently follows up orders to make certain that deliveries will be made on time. Since the larger resident buyers have specialists in each line of goods purchased for their customers, much time is saved for the visiting buyers and the assistance rendered in making purchases is extremely helpful.

When their clients' buyers are not in the city, orders may be sent directly to the resident buyers. They also do some purchasing in large quantities by pooling the requirements of those they represent. When this is possible, more attractive prices and terms may be secured than the individual buyers could otherwise obtain.

CASE PROBLEMS—I

The student book store operated in connection with a state university is in the process of building a new and much larger store. Because of changes in the

[11] For further discussion, see Clare W. Barker, Ira D. Anderson, and J. Donald Butterworth, *Principles of Retailing*, 3rd ed. (New York: McGraw-Hill, 1956), pp. 223–6.

size of store and in the method of operation, new fixtures are also required. An architect is employed who specializes in store fixtures, and eventually drawings are made and bids called for. Three bids are received from fixtures manufacturers: one for $59,750, another for $78,925, with the third amounting to $81,230. The architect states that the low bid is unreasonably low, that quality fixtures cannot be obtained for that price, and that his estimate of a fair price for quality workmanship is about $80,000. He recommends that the contract be awarded to the second low bidder.

The two low bidders are then requested to appear before the board of directors of the store to discuss the matter. The second low bidder states that he employs the finest craftsmen available. Most of them are elderly persons of European stock who have emigrated to the United States. Pride of workmanship is traditional with them, since most of them belong to families that have followed the particular craft for generations. The low bidder indicates that he has found no error in his bid and that he sees no reason why he cannot provide serviceable fixtures and make a profit on the contract. He employs union workmen and states that they are good craftsmen.

As a result of the two interviews, the members of the board of directors conclude that the low bidder needs the work and that he has not allowed much margin for profit. The possibility exists that he may even incur a loss on the contract. There is also no question in their minds that the fixtures produced by the low bidder are serviceable but somewhat inferior in appearance. What decision should be made by the board? Why?

II

The manager of this same student book store shortly after World War II was presented with the opportunity of purchasing 1,000 used wrist watches "as is" from the armed services for one dollar each. These watches were of high quality, probably worth $60 or more at retail when new. They were accurate timepieces, having been used by Air Force personnel in operations involving close synchronization as to time. It was estimated by the manager of the store that the total cost of the watches, including the cost of necessary repairs, would not exceed $5 each and that they could be sold as a special for $10, thus providing a bargain for the students and a good profit for the store. At the time there were about 6,500 students at the university served by the store, two thirds of them men.

One of the members of the board of directors pointed out that the store, although it did handle various lines of general merchandise, had no experience with watches. He believed that the cost of putting the watches in serviceable condition might well run considerably higher than $4 each and that no more than 700 or 800 serviceable watches might result from the purchase. This board member stated that unanticipated costs together with federal excise taxes might well result in a final price of $20 rather than $10. He also raised the question of what type of guarantee would have to be given with the sale of the watches.

Should the purchase have been made? Why or why not?

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20. PHYSICAL DISTRIBUTION

The functions of physical supply involve the creation of place utility through transportation and the creation of time utility through storage or warehousing. These two functions must be closely coordinated in modern marketing because of their complementary relationship. Increasingly, the manufacturer and wholesaler and retailer must compare complete systems of physical distribution with respect to cost and efficiency. Savings incurred by choosing certain methods of transportation may be more than offset by increased warehousing costs. More to the point is the general problem of establishing a policy of physical distribution. What methods of transportation should be used, service and cost considered? How many warehouse locations should be established to insure proper service to customers? And how will transportation costs be affected by the number of such locations selected? Would it be preferable to utilize a rapid but expensive method of transportation in order to curtail or even eliminate the necessity for warehousing? These and similar questions are of great importance to marketing management.

It is thus evident that many decisions must be made with respect to transportation, storage, and related aspects of physical distribution such as order handling and billing. For example, those who use the transportation system have at their disposal a wide variety of facilities and services. The choice of the best facility or service for the purpose is not always an easy one and may require the judgment of a highly skilled traffic manager. The cost of transportation must always be balanced against the services rendered, and judgment must be made as to the service required. Similar problems arise with respect to the choice of storage facilities and services.

It is not possible in the space available to examine all the various facets of these problems, but the discussion in this and the following chapter will attempt to present a general picture of the facilities and services available.

The present chapter is concerned with the transportation agencies and their relative importance and with transportation costs and rates. In the following chapter, transportation service and storage service will be the principal topics, followed by a brief discussion of recent developments in the management of the physical distribution function.

TRANSPORTATION AGENCIES

The modern and highly developed marketing system which we have in the United States is largely dependent upon the existence of a great variety of transportation agencies. During the late twenties, total intercity freight traffic amounted to approximately 600 billion ton-miles per year. By the end of the fifties, public and private carriers were transporting more than 1,300 billion ton-miles of goods per year. A tremendous network of railways, highways, inland waterways, pipelines, and airways is required to furnish this large volume of transportation service. A great variety of facilities must be maintained to transport raw materials to the place of production and finished goods to the point of consumption. Without these facilities, mass marketing and mass production would be impossible.

Changes in transportation methods and the development of new agencies have led to widespread changes in marketing methods and in marketing institutions. For example, in an era when the nation was largely dependent upon slow and roundabout water transportation, market areas tended to be restricted and the wholesaler was a vital link in the channel of distribution. As transportation became more rapid and flexible with the development of railroads and, at a later date, the motor truck, it became possible for manufacturers to achieve national distribution and to market directly to retailers. These developments in transportation also led to the widespread distribution of perishable commodities, something that was previously impossible to accomplish on a large scale. Similarly, the establishment of a vast railroad network permitted the federal government to operate a comprehensive parcel post service which in turn stimulated the development of the large mail order house. Many other examples could be cited, but these are sufficient to indicate the close relationship between transportation and modern marketing. In recent years, important changes have again taken place in the transportation system which have had great significance for marketing. These changes have involved all of the major types of carriers: the railroads, motor carriers, inland water carriers, pipelines, and airlines.

Rail transportation has long been regarded as the basic element of the American transport system, and as recently as the late twenties and early

thirties, railroads handled 75 per cent of all intercity freight traffic. In 1957 the number of revenue ton-miles of freight handled by the railroads was almost 40 per cent greater than the comparable figure for 1926, but the railroad's share of total traffic amounted to only 46 per cent.[1] This decline in relative importance has been a virtually continuous one except for the war years of the forties.

The share of total intercity freight traffic obtained by motor trucks and pipelines, on the other hand, has increased remarkably since the late twenties. Inland waterway traffic has shown little relative change between 1926 and 1958, amounting to 16 or 17 per cent of total traffic in each year.[2] Motor trucks, however, during this period of some 30 years have increased their share of the total intercity traffic from approximately 3 per cent to more than 20 per cent, or from 16 billion ton-miles in 1926 to 247 billion in 1958. The growth in oil pipeline traffic has been almost as great during the period, from less than 4 per cent of the total to more than 17 per cent. Airline traffic, of course, has grown relatively more than has any other type, but the amount of commodity traffic handled by airlines is still a negligible quantity. In 1958 it was considerably less than one billion ton-miles, or about 0.05 per cent of total traffic.[3]

Railroads

Despite the fact that railroads have lost a great deal of traffic to other types of carriers, they are still the most important form of transportation in the United States. As of 1957 railroads owned more than 1,700,000 freight cars and 30,000 locomotives.[4] Their total net investment amounted to more than $30 billion, and they operated some 232,000 miles of main track. Although there are 650 different railroads in the United States, 96 per cent of total railroad mileage is operated by the 110 Class I railroads—those with

[1] For detailed statistics of the shares of traffic handled by the various types of transport agencies and the shifts that have taken place since 1926, see James C. Nelson, *Railroad Transportation and Public Policy* (Washington, D.C.: The Brookings Institution, 1959), pp. 8–17 and 439–42. See also the *Annual Reports of the Interstate Commerce Commission.*

[2] This figure includes inland waterway transport only and excludes coastwise domestic traffic between the various ports of the Atlantic, Gulf, and Pacific coasts.

[3] Airline traffic, including express, mail, and excess baggage, amounted to only 579 million ton-miles which constituted 0.048 per cent of the total. The corresponding figures for 1939, however, were 12 million ton-miles and 0.002 per cent. See James C. Nelson, *op.cit.*, p. 442; and the 1959 *Annual Report of the Interstate Commerce Commission,* p. 11.

[4] Charles A. Taff, *Traffic Management: Principles and Practices* (Homewood, Ill.: Irwin, 1959), p. 65. See also *Statistical Abstract of the United States, 1959* (Washington, D.C.: U.S. Government Printing Office, 1959), pp. 567–9.

gross operating revenues in excess of $3 million per year. These same Class I railroads obtain 99 per cent of total railroad freight and passenger traffic.

The principal advantage of the railroads in relation to other forms of transportation is that they provide a more complete and a more varied transportation service. They are available to haul any commodity any distance to almost any destination in the country. Many different types of equipment are provided to meet the needs of shippers with special problems. With respect to freight cars, for example, various types and sizes of boxcars are provided for different classes of commodities.[5] In addition, there are flatcars, tank cars, gondola and hopper cars, refrigerator cars, stock cars, and various special types. Certain commodities may require a different kind of car at different times of the year, as in the case of fresh fruits and vegetables which require refrigerator cars for summer shipment and heater cars during the winter.

Freight trains are operated at a variety of speeds to accommodate shippers' needs. "Expedited service" trains have the fastest schedules and sometimes involve an extra charge for guaranteed delivery at destination within a specified period of time. Bulk or low-rated commodities are often hauled on an unscheduled basis; that is, the train is dispatched whenever a sufficient number of loaded cars have been accumulated to make it worthwhile.

Railroads also offer many special services that are not available from other forms of transportation. Illustrative of the type of service involved is the diversion privilege which permits a shipper to change the ultimate destination of a rolling shipment at certain terminals designated as diversion points, and still pay the through rate for the commodity from the point of original shipment to the new destination. In addition, railroads are now offering "piggyback" service, an arrangement whereby loaded truck trailers are hauled on railway flatcars. These and other special services will be discussed at length in the following chapter.

Despite these service advantages the railroads, as previously noted, have lost a large share of their traffic to other forms of transportation. Water carriers have always been important competitors of the railroads for bulk goods requiring a low freight rate. In recent years, the motor carriers have developed rapidly as competitors for the more highly rated traffic in manufactured commodities, and have also made substantial inroads in the hauling of some bulk goods including certain agricultural products. The growth of pipeline transportation has been previously mentioned. In order to have a complete picture of the transportation system, it is necessary to discuss briefly these other forms of transportation.

[5] For further discussion, see Chap. 21.

Water Carriers

The original pattern of our industrial system was largely determined by the location of inland waterways, and many of our great markets developed because of their proximity to water transportation. With the development of railroads in the nineteenth century and of motor transportation during the twentieth, less reliance on water transportation was required. Nevertheless, coastal and inland waterway transportation is still an important part of the domestic transport system.

Coastwise traffic moves along the Atlantic, Gulf, and Pacific coasts because of the large centers of population adjacent to excellent harbors and the development of sheltered waterways connecting many of the ports. There is also a small amount of traffic between Pacific and Atlantic ports through the Panama Canal. The Great Lakes and their connecting channels constitute the principal inland waterway in this country, as well as a route for international commerce in conjunction with the St. Lawrence Seaway. They furnish a natural transportation route connecting the grain fields of the northern Mississippi Valley and the iron ore deposits at the head of Lake Superior with the eastern grain markets and the steel producing region south and east of Lake Erie. The important raw materials of these sections are all commodities of great bulk in relation to value. Speed in their transportation is not of primary importance, and they can be easily stored for considerable periods of time. Low-cost water transportation is, therefore, an ideal means of carrying them, even though there are several months in the year when lake shipping is closed.

Next to the Great Lakes in importance are the Mississippi River and its tributaries. This great river system has been extremely important in the commercial development of the Middle West. It has provided a means of transportation between the northern and southern areas of the country, while the Ohio River has furnished a connecting east-west water route. These waterways were of inestimable value in the early history of this section, and the actual and potential competition of boats plying the Mississippi and other internal waterways, such as the Tennessee River, has also been a significant influence in reducing rates on competing railroads. During the past 30 years, the federal government has been quite active in financing improvements in channels and extensions in the inland waterway system. The result has been a considerable increase in river traffic.

As a matter of fact, the relative importance of the various inland waterways in our transport system has changed considerably since the twenties and

especially since World War II. During the twenties, the Great Lakes system contributed approximately 90 per cent of all inland waterway traffic—measured in ton-miles hauled. As recently as 1947, the corresponding figure was still more than 75 per cent. By the late fifties, however, river and canal traffic was almost equal to that carried on the Great Lakes.

The low cost of water transportation as compared with carriage by rail is recognized as its most important advantage, and almost the only reason it is used in preference to rail or motor transport when these are available.[6] One of the chief disadvantages of water transport as compared with other means of transportation lies in the fact that it is generally slower. Its use is, therefore, ordinarily limited to the carriage of products in the distribution of which time is not an important element.

Domestic water transportation is further largely limited to commodities that originate in or near water terminals since the expense and time incident to transshipment are often prohibitive.[7] Furthermore, in the northern states many rivers and connecting waterways freeze over in the winter months. Another important disadvantage results from the fact that water carriers can reach only certain points in large cities, whereas railroad cars can be switched to elevators, warehouses, factories, and wholesale markets. But in spite of these limitations water transportation, where it is available, is likely to remain important in the carriage of bulky commodities which do not require special facilities for preservation.

Motor Carriers

The rise of the motor truck to its position as the second most important carrier of intercity freight is undoubtedly the most significant recent development in transportation. In addition, the motor truck plays a most essential role in the intracity movement of goods. It complements railroad and water transportation by hauling a large proportion of such shipments to and from the rail terminals and water carrier docks. The delivery of manufactured goods and other products from factory to wholesale warehouse to retail store within urban areas is largely accomplished by motor transport.

The motor truck has made it possible to make deliveries in nearby territory with great speed. This has enabled wholesalers and retailers to operate

[6] When waterways are created or maintained at governmental expense and when these costs are added to the rates charged by water carriers, the total cost of water transportation is often above that of competing forms. The added cost, of course, is borne by the taxpayer rather than by the immediate users of transportation service.

[7] The inauguration of "fishyback" service, whereby truck trailers are carried on ships, may serve to lessen this disadvantage.

with smaller inventories and so has tended to reduce the size of single orders and to increase the number of deliveries made to individual customers. The result has been to shift a part of the burden of carrying stocks from retailers to wholesalers and from retailers and wholesalers to manufacturers.

The motor truck has made large inroads in railroad traffic.[8] Because of the comparatively small size of the transportation unit, it is particularly well adapted to the hauling of less-than-carload quantities. The truck also has an advantage in speed and flexibility over short distances. Thus short-haul and l.c.l. traffic were quickly diverted from the railroads to motor carriers as early as the twenties, especially for those commodities which carried high freight rates. But motor transportation is by no means confined at present to these two types of traffic. Highways have been much improved since the twenties and truck and trailer combinations have increased greatly in size. Motor carriers are now substantial competitors for virtually all high-rated traffic.

The diversion of traffic from railroads to trucks has taken place both in manufactured goods and in agricultural products. For example, over half of the new automobiles manufactured are transported from factory to market by means of trucks. Studies of the shipment of iron and steel products indicate that in the northern and eastern parts of the United States about 50 per cent of the total tonnage moved by truck in 1953. In some parts of this area, motor carriers were hauling as much as 70 per cent. Manufactured tobacco products, canned fruits and vegetables, and building materials are other examples of manufactured goods, and numerous others could be cited, that have been transported in increasing quantities by motor carriers during recent years.[9]

Agricultural commodities, especially the more perishable items, are also transported to an increasing extent by truck. Over 90 per cent of the milk supply of several large cities was received by truck as early as 1930. In 1936, 44 per cent of the fresh fruits and vegetables received at 40 markets were brought in by motor carriers.[10] Most of these hauls were for short distances and a large proportion of them were made by farmers in their own trucks. But by 1940, the transportation of apples by truck from the state of Washington to Los Angeles—a distance of about 1,200 miles—was commonplace, and truck receipts in the Los Angeles market exceeded rail receipts. A similar

[8] It should be held in mind that motor trucks, unlike railroads except in a very few instances, may be privately owned and operated. Almost half of all intercity tonnage moving by truck is carried by privately operated vehicles rather than by carriers operated on a for-hire basis.

[9] For more detailed information, see James C. Nelson, *op.cit.*, Chap. 3.

[10] Clifford C. Matlock, *Trends in Railroad Traffic, Freight Rates, and Prices, Perishable Agricultural Commodities, United States* (Washington, D.C.: Bureau of Agricultural Economics, U.S. Department of Agriculture, 1941), pp. 3–5.

situation existed in the transportation of livestock. Between 1932 and 1940, truck receipts at all public markets increased from 33 per cent of total receipts to 66 per cent for cattle and from 50 per cent to 68 per cent for hogs.[11]

And these trends have continued since World War II. For example, truck receipts at Chicago in 1955 amounted to 89 per cent of total receipts for two dairy products compared with 52 per cent in 1939; for seven fruits and vegetables the figures were 28 per cent in 1955 and 15 per cent in 1939; for four livestock groups 90 per cent and 37 per cent respectively; and for four poultry and egg products 98 per cent and 66 per cent.[12]

Although much of the truck volume is still in relatively short-haul traffic, the trucking radius has tended to expand over the years. The railroads still retain most of their long-haul traffic in bulky commodities of low value. But much of the traffic in high-value commodities has been taken over by the trucks even where relatively long hauls are involved. And truck transportation has also made inroads on rail freight in the hauling of bulky low-value items for short distances. The reasons for the substantial development of motor carrier transportation lie partly in the inherent advantages of truck service and partly in other factors.

Advantages of Motor Carrier Service. Motor transportation has several basic advantages in relation to rail transport. These include greater speed and flexibility, less expensive packaging of shipments and more personalized service, and in some cases at least lower costs and rates.

Truck service is usually faster and more flexible than rail service, particularly for short hauls and for less-than-carload shipments. The truck is commonly loaded at the consignor's place of business and unloaded at the consignee's door. This eliminates the delay and inconvenience, as well as the extra handling, involved in transporting shipments to and from the railroad. The truck is quickly loaded, and when loaded it can start at once. Railway freight stations have definite hours of business and shipments can start only when a train is made up and ready to go, whereas the shipper's own trucks or the commercial trucking firm can often arrange special trips to meet emergencies. Truck shipments tend to take a direct route from point of shipment to destination with little or no intermediate handling, whereas rail shipments may require a more roundabout routing and a considerable amount of switching and handling at junction points. An important result of these advantages is that with truck transportation it is possible to load merchandise late in the day and make early morning deliveries at points several hundred miles distant.

[11] Edna M. Jordan, *Drive-In Receipts of Livestock, 1940* (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, 1941).

[12] *The Marketing and Transportation Situation*, April 26, 1956, p. 17.

Much improvement has been made in recent years by rail carriers in increasing average train speed. Moreover, pickup and delivery service is often rendered in connection with less-than-carload freight, but motor carriers still have an important advantage in speed and flexibility of service.

Motor carriers also have an advantage in the shipment of products requiring personalized service and special packing. Many items must have expensive packaging or packing if they are to be shipped by rail. Motor carriers are able to transport these products with less handling and switching, and thus with less expensive packing and less risk of damage. Shipments are more easily protected against shock and vibration in motor trucks than in railway freight cars with less likelihood of breakage or other damage.

Finally, motor carrier costs for short hauls are likely to be lower, or at least no higher, than the cost of similar rail hauls. Railroads normally have a cost advantage in comparison with truck transportation, but the rates for short hauls by rail must absorb a high terminal cost at each end of the haul. The terminal cost, however, becomes a smaller and smaller part of the total cost of transportation as the distance increases. Thus railroad costs reflect a "distance tapering" principle, i.e., cost per mile decreases as the distance increases, to a much greater extent than do truck costs. The result is that the cost advantage of the railroads on long hauls tends to be reduced, and even to disappear, as hauls become shorter.

Other Factors Favoring Motor Carrier Development. Certain changes in the economy have also favored the development of motor carrier transportation. The trend toward decentralization, both in manufacturing and in marketing, has reduced the average length of haul. In the case of manufactured goods, industry has tended to locate new plants near developing markets. The decentralization movement in the marketing of agricultural products, as discussed previously in Chapter 4, has eliminated many of the long hauls to terminal markets that were once characteristic. The greater emphasis throughout the economy on shorter hauls has obviously favored motor carrier transport, which has many short-haul advantages.[13]

These changes, of course, do not explain the inroads of the motor carriers in the transportation of goods over medium and long hauls, where the rail-

[13] It may be argued, of course, that the development of motor transportation has led to the decentralization of manufacturing and marketing rather than the reverse, and certainly this is true. See, for example, Benjamin Chinitz and Raymond Vernon, "Changing Forces in Industrial Location," *Harvard Business Review*, January–February 1960, esp. pp. 130–2. The point is that, regardless of which is the cause and which the effect, present-day trends in the location of manufacturing and marketing facilities favor the continued use of truck transportation. Chinitz and Vernon, however, feel that there may be a reversal of this decentralization trend as a result of new developments in long-haul transport such as "piggyback" transportation, airline cargo service, and increasingly competitive railroad rates.

roads tend to have more of a cost advantage. To a considerable extent, the explanation lies in the lack of aggressive rate competition on the part of the railroads and in the regulatory restrictions that are imposed upon the railroads. As traffic has been diverted to motor carriers, the railroads have become more and more aware of the necessity of establishing rates on high-value merchandise that reflect more accurately the costs of transporting such goods. Rate changes, however, cannot be freely made, approval by the Interstate Commerce Commission often being required. Not only is the process likely to be a long and laborious one but proposed rate reductions frequently are not approved by the Commission. Thus railroads have been hampered in such efforts as they have made to reduce rates. In a number of instances when rate reductions have been approved, railroads have been successful in regaining traffic that had been diverted to motor transport. The future development of motor carriers, especially with respect to medium- and long-haul traffic, is thus closely related to pricing and regulatory policy. At present, many authorities are advocating a relaxation of transport regulation to permit more competitive rate-making on the part of the railroads.[14] If this is done, it is unlikely that motor carrier transport will continue to grow quite as rapidly as it has in the past.

Pipelines

Transportation by pipeline, like motor carrier transportation, has increased substantially during the past three decades. But this form of transportation is virtually confined to the petroleum industry.[15] In 1957 there were 145,000 miles of petroleum pipelines in the United States operated by 82 companies and carrying approximately 17 per cent of the total ton-miles of intercity traffic.

The pipeline is a highly inflexible and specialized carrier in that it transports a single commodity in one direction only. Although directions can be reversed by resetting pumping stations and although crude oil lines are oc-

[14] See, for example, *Revision of Federal Transportation Policy*, a Report to the President, Presidential Advisory Committee on Transport Policy and Organization (Washington, D.C.: 1955); and the review of this report by James C. Nelson, "Revision of Transport Regulatory Policy," *American Economic Review*, December 1955, pp. 910–8. More recent statements include James C. Nelson, *Railroad Transportation and Public Policy*, *op.cit.*; and *Federal Transportation Policy and Program* (Washington, D.C.: U.S. Department of Commerce, March 1960).

[15] The discussion here is confined to oil or petroleum pipelines and does not include natural-gas pipelines which are not in competition with other means of transportation. Petroleum products are transported by truck, railroad, and water carrier as well as by pipeline, whereas the only practical method of transporting natural gas is by pipeline. There is also some use of pipelines to transport coal as slurry.

casionally changed to refined product service and vice versa, these are rare exceptions to the general rule. Thus there must be a continuous volume of traffic available from one geographical point to another for a pipeline to be constructed. This traffic normally involves bringing crude oil from the wells to concentration points and then to refineries, and to a somewhat lesser degree the transportation of gasoline and other refined oil products from refineries to storage points near large markets.[16]

The construction of pipelines requires a large financial outlay. There is also substantial risk involved for the ordinary independent business which, once the line is constructed, must depend upon relatively few shippers for traffic. For these reasons, pipelines are generally owned and operated by the large oil companies which also are the shippers of petroleum products. Such lines may or may not offer their services for the transportation of products owned by other firms.

When sufficient volume is available to warrant the construction of pipelines, the resulting cost of transportation tends to be very low in relation to railroad and truck costs. Furthermore, there is no problem of empty equipment to be sent back to the point of origin as there is likely to be in other forms of transportation. For these reasons, petroleum products are carried by pipeline whenever possible, or by water carrier, which is likely to be comparable in cost; but a substantial quantity of both crude oil and refined products still moves by truck and railroad because of the lack of sufficient volume to warrant the construction of pipeline facilities.

Airlines

The transportation of freight and express by airlines is a relatively recent development. Express service has been available on an organized basis, through contracts between the airlines and the Railway Express Agency, since 1928. General cargo service, at least on regularly scheduled airlines, has been available only since 1944 when certain restrictive provisions of the contracts with Railway Express were removed. As indicated previously air transport is growing rapidly, although only a negligible portion of the total movement of goods is being carried by this means. At present, air freight and express service is available from regularly scheduled cargo-only carriers and from supplemental charter operators as well as from the regularly scheduled passenger airlines.

Obviously, the principal advantage of air transportation lies in the speed

[16] Approximately 80 per cent of pipeline volume is in crude oil and 20 per cent in refined products. See *Statistical Abstract of the United States, 1959, op.cit.*, p. 583.

with which goods are carried, and the main disadvantage is its high cost. Air transport also has some physical limitations as a result of the basic design of the plane. Cargo space is limited and weight must be distributed. Accordingly, shipments have to be restricted to items which do not exceed certain dimensions or occasionally certain weights per square foot of space occupied. Air transport is thus most appropriate for goods of relatively high value and low weight for which there is a particular need for speed in transportation. As of 1955, the commodities most frequently shipped by air freight were as follows: automobile parts and accessories, machinery, electrical equipment, cut flowers, wearing apparel, machine parts, printed matter, films, aircraft parts and accessories, and drugs and biologicals.[17]

It might logically appear that air transport would be most useful for relatively perishable products. For such items, the high cost of transportation might well be more than balanced by savings in deterioration and by delivery to the market of a fresher product. But such does not appear to be the case. Of the principal traffic products listed above, only cut flowers is of this type. Traffic in such items as fresh fruits and vegetables and seafoods has not equalled expectation. Apparently, the service rendered by other methods of transportation is sufficiently satisfactory, at least in relation to its cost, that little diversion of traffic has taken place. On the other hand, the use of airlines in the transportation of wearing apparel is completely logical. Fashion "perishability" is involved here and speed in transportation permits smaller orders and less risk of inventory obsolescence, as well as lower packaging expense.

Products such as automotive parts, machinery, and equipment do not appear off-hand to be the types of items that would utilize air transport extensively. Undoubtedly there is an element of emergency involved at times in the need for these products. A machine breakdown which disrupts production of an entire plant is very costly, and the high charge paid for prompt transportation of a replacement part is a negligible business expense under the circumstances. Many shipments of parts and equipment, however, are routed by air carrier as a matter of regular policy. The shippers are usually small firms with limited storage space at the plant and no warehouse facilities at destination, and they operate in highly competitive and somewhat distant markets. By using air transportation, they can provide prompt service at a lower cost than if warehouse and other facilities were maintained near the market. In most instances the size of individual shipments is small, and

[17] Listed in order of pounds carried by three domestic trunk lines and one all-cargo carrier. See Howard T. Lewis, James W. Culliton, and Jack D. Steele, *The Role of Air Freight in Physical Distribution* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1956), p. 27.

the cost of transportation is low in relation to the value of product.[18] Fragility of product is also a factor in the use of air transportation in some instances, e.g., the shipment of electronics items from California to the eastern part of the country.

The future of air cargo transport rests primarily upon its ability to reduce costs and rates. Transportation cost to the shipper by airline is likely to be from two to five times as great as by truck or rail. The offsetting savings in reduced warehousing and inventory costs in most instances are not likely to be sufficient to cause most shippers to turn to air carriers. One of the problems involved in reducing air rates is the directional unbalance of traffic and thus the difficulty of obtaining complete utilization of facilities. Planes used solely for freight purposes have difficulty in obtaining pay-loads for return flights, and the cost of flying empty is almost as great as that of transporting a regular cargo. At one time, motor carriers were also confronted with this problem although certainly not to so great a degree. Obviously, the problem was largely solved for the motor carriers as shippers began to use truck transportation for a greater variety of commodities. Similar developments will help the airlines to some extent, but they appear to be a long way from achieving directional balance.

TRANSPORTATION COSTS AND RATES

Effect of Costs on Marketing

The cost of transporting an item limits the area in which a given producer or middleman can sell it. When other costs are equal, the seller who enjoys the lowest transportation costs in obtaining materials and supplies and in shipping the finished product to market has an important advantage in relation to competitors. Factories are located with a view to the cost of transporting raw materials to the factory and the cost of carrying the finished product to its market. Warehouses and wholesale firms are located so as to take advantage of low transport costs from supply centers. Some cities have outdistanced rivals, with otherwise equal natural advantages as manufacturing and distributing centers, because of lower transport costs to consuming and raw material markets. Great productive areas of the globe are as yet unopened to world commerce, not merely because their transportation services are meager but because the cost of these services is prohibitive.

[18] For a more detailed discussion, see Howard T. Lewis, James W. Culliton, and Jack D. Steele, *op.cit.*, Chap. 2.

Improved methods of transportation have brought lower costs and rates as well as superior service. But the relative level of transport rates is still important. California oranges could not compete in eastern markets with those of Florida were it not for the relatively low (per mile) freight rates from California. And many eastern manufacturers in the past have actually had a competitive advantage over midwestern firms in trade with the Pacific Coast, because the combined rail and water rates from eastern points to these markets were lower than the rail rates from the Middle West.

The effect of freight rates on markets varies greatly. The rate on articles for personal consumption often has little effect on the retail price. A difference of several cents per hundred pounds in the rate may amount to less than a cent on individual items sold to the consumer. Such differences are very important, however, in the wholesale trade, and particularly with respect to bulky and low-value articles. They may cause a purchasing agent to procure raw materials from one source rather than from another, and they give wholesalers of one city an advantage over those located in other cities in selling to certain retail markets. The cost of transporting raw materials in relation to the cost of transporting the finished products determines whether materials will be processed near their source or near the finished goods market. Slight changes in rates, as well as the development of new forms of transportation, have caused great changes in commercial relationships established under a former tariff.

Transportation costs to the shipper or consignee are most often determined by the rates established by the railroads.[19] Water carrier rates, of course, are usually lower than railway rates, and the same is true of pipeline rates. But water and pipeline transportation are limited in their availability. Where water transport does exist, railroads may be forced to adopt rates between points so connected which are considerably lower than the rates for the same service points that do not have such transportation available. Pipeline rates, on the other hand, are usually so low that the railroads do not even attempt to meet them. Although motor carriers are of considerable importance in the transportation system, as has been pointed out previously, they are seldom aggressive competitors with respect to rates. Generally speaking, although there are some exceptions, they follow the lead of the railroads and establish rates at or somewhat above those of the railroads, relying upon their natural advantages to obtain traffic at these rates. Since the railroads may be regarded normally as the rate leaders, it is desirable to discuss at some length how their rates are determined.

[19] The cost of private trucking is also important in this respect in some instances, e.g., in the food wholesaling industry.

Railroad Rates

The General Rate Structure. There are few rules of rate-making which are consistently followed. The fact that many railroad costs are joint or common costs complicates the situation. Tariffs are built up with a view to obtaining as much traffic and revenue as possible. So long as a given rate pays the additional, or "out-of-pocket," cost of carrying a product and some part of the common costs of operating the road, the traffic is considered profitable. Obviously, the railroad is better off financially than it would be if that commodity were not carried—providing transportation of this low-return freight does not prevent the road from carrying products that pay a more profitable rate, a situation which seldom exists. Thus it is possible for the rate for a specific commodity to be set at any one of several levels, subject, of course, in some instances to the competition of other types of carriers. In practice, most rail rates are a result of compromise between the railroads and the shippers, and between different roads competing for the same business or trying to develop the business of the territories from which they draw traffic. The Interstate Commerce Commission and various state commissions act as umpires, and frequently have ideas of their own as to the rates that should be charged.

The cost of providing transportation service is generally dependent upon, or at least related to, distance and the special care that must be taken in transit and at terminals. Cost of service serves as a lower limit to rates, but bulky articles could seldom be carried far if charged the full cost of the service. Thus the value of a commodity in relation to its shipping weight and bulk must also be considered, and so bulky articles of low value may be carried at rates which just cover the additional or out-of-pocket costs of carriage. Articles of high value, however, tend to be carried at more remunerative rates, with consideration being given to value of service, i.e., "what the traffic can reasonably be required to bear," [20] unless competition from other carriers is such as to force rate reductions.

Rates do not increase directly in proportion to distance, but they are greater for longer hauls. This difference is great enough to limit the market areas into which most goods can be shipped and sold at a profit. Low costs of production or a favorable reputation with buyers may extend the area for one product as compared with similar products, and special rates may help distant shippers to reach markets, but ultimately the limit of profitable sale is

[20] *Value of Service in Rate-Making* (Washington, D.C.: Bureau of Transport Economics and Statistics, Interstate Commerce Commission, November 1959), p. 1.

reached. In the case of perishable commodities, distant shippers are frequently forced off the market when abundant local supplies become available, since prices may drop so low they do not even cover the cost of transporting from distant shipping points. But for many products, rates can be made low enough to enable shippers from distant points to compete in given markets with nearby producers. These comparatively low rates on long hauls are justified not only because of the existence of common costs but also because of other aspects of the nature of railway costs.

Freight shipment involves two kinds of costs to the carrier, terminal and line-haul. Terminal costs are involved in the handling of the shipment both at origin and destination, and they are the same regardless of the distance the shipment travels. Line-haul costs are those involved in the actual transport of the goods between terminals. Such expenses are somewhat proportional to distance but actually tend to be less per ton-mile the greater the length of the haul. The reason for this is that it is more economical to operate the more completely loaded through train than it is the partially loaded short-haul local train. Consequently, railroad rates are established according to the "distance tapering" principle mentioned earlier: the rate per ton-mile decreases as the distance covered increases. Such a rate reflects not only the line-haul economies of volume in relation to distance but also the fact that terminal costs are spread over more miles.

Rates on different goods shipped the same distance or between the same points have varying effects on the prices of these goods. The principal factor involved is the relation between bulk, weight, transport cost, and market value. Goods of high value may pay a very high rate, at least in relation to bulk and weight, and yet the rate may make little difference in prices as between markets. Minnesota butter, for example, is likely to sell at approximately the same price in Minneapolis, Chicago, and New York; but prices for grain at local shipping points and at terminal markets show a wide variation, which is closely related to the cost of transportation. Shoes and textiles can be shipped substantial distances with little effect on the retail price, but market areas for steel and cement are limited by freight costs.

The need for special care in shipment adds to the costs of carriage and affects the rates. Packages add to the weight of goods shipped and thus to the cost of shipment, in addition to the initial cost of the package itself. Special cars, special trains, and special services add to the cost of transporting perishable fruits and vetegables and livestock. Special terminals or terminal services must also be provided for some products.

Freight Classification. In order to simplify the merchanical problem of rate-making, all commodities are grouped into classes, and rates are estab-

lished as percentages of the basic class. A schedule is used showing the rate per 100 pounds of transporting the basic class of freight every possible distance that it may be carried. Rates for other classes of commodities are established by applying the appropriate percentage of the base rate. For example, the Uniform Freight Classification adopted in 1952 is now the basic classification system used in the United States.[21] In this system, commodities are grouped into 31 classes ranging from Class 400 to Class 13. Commodities in Class 100 take the basic 100 per cent rate. Those in Class 300 are charged three times the basic rate and those in Class 50 only one half of it.[22] Thus the designation of the class indicates the appropriate percentage of the base rates applicable to all commodities in that class. Commodities are assigned to a specific class according to some 50 characteristics that affect the cost and value of transportation service.

The significance of the freight classification system is that a rate can be obtained immediately and relatively easily for any and every commodity that a shipper might desire to have transported. However, commodities that are regularly offered for shipment in volume usually are subject to special commodity rates that are established by the carriers as a result of lower unit costs and in order to encourage traffic. Most agricultural products, lumber and forest products, iron and steel, coal, cement, and brick are examples of products which are subject to special commodity rates, at least in those areas where there is a significant volume of traffic. As a matter of fact, some 75 per cent of all rail freight is hauled at these special commodity rates.

Commodity rates are lower than the corresponding class rates, but they are not necessarily available from all points of origin. Shippers who have commodity rates available have a competive advantage over those who do not. For example, it has been the case at times with some products that Seattle wholesalers were able to ship at commodity rates whereas Spokane shippers had to use the higher class rates. The reason was that Seattle, being the larger wholesale center, had long shipped a substantial volume of these items. Spokane wholesalers, attempting to add these products to their lines, were not able to compete on an equal basis in the intermediate markets until commodity rates were established. Thus the significance to the shipper of having commodity rates established is evident.

[21] At one time, there were three separate rail classification systems in use in different regions of the United States. The Uniform Freight Classification has now replaced these separate classifications, except that a different classification is still in partial use in Mountain-Pacific Territory. Motor carriers use the National Motor Freight Classification of which there are currently two versions in use. See Charles A. Taff, *op.cit.*, Chap. 6.

[22] The classes are as follows: 400, 300, 250, 200, 175, 150, 125, 110, 100, 92.5, 85, 77.5, 70, 65, 60, 55, 50, 45, 40, 37.5, 35, 32.5, 30, 27.5, 25, 22.5, 20, 17.5, 16, 14.5, and 13.

Carload and Less-than-Carload Rates. The standard classification system usually provides for a higher class when products are shipped in less-than-carload quantities than when they are shipped in carload quantities. For example, aluminum extrusions in l.c.l. quantities are in Class 85, but they carry a Class 50 rate when shipped in carloads of at least 30,000 pounds. The reason for such differentials is that the expense of loading, carrying, and unloading carlots is less than that for the same product shipped in less-than-carload lots. Clerical costs are much the same and so are relatively higher for l.c.l. amounts. Moreover, carloads are usually loaded by the shipper and unloaded by the receiver; thus these costs are not incurred by the carrier.

It is these higher rates for l.c.l. shipments that make it necessary to concentrate some agricultural products at country shipping points so that carlot quantities can be assembled for shipment to terminal markets. This difference in rates is also often the reason why retailers buy from wholesalers or from manufacturers' branch warehouse stocks in preference to direct l.c.l. shipments from the more distant manufacturing plant. The difference between l.c.l. and carload rates is particularly important when transportation charges make up an important part of the final cost of the product. In this situation, every effort is made to get products as close as possible to the ultimate point of consumption by carload shipment. The growth of local wholesaling and the relative decline in national and regional wholesaling that have taken place in recent years have resulted in large part from the desire of shippers to take advantage of these lower carload rates.

Shipping by less-than-carload freight has not only the disadvantage of higher rates but other disadvantages as well. Shipments which can go unpacked in carlots must be packed for l.c.l. shipment; and shipments normally packaged in any event often must be packed in heavier and more expensive containers when shipped in l.c.l. quantities. This causes additional expense to the shipper and adds to the weight of the shipment. Despite this extra packaging, losses from breakage and other causes are often substantial. Moreover, cars in which l.c.l. freight is shipped are frequently not loaded to capacity, and thus the service requires a larger number of cars than the tonnage would indicate. Finally, l.c.l. service tends to be slow, and additional handling in terminals is likely to be necessary.

It is for these reasons that much of the less-than-carload freight volume has been diverted from the rails to motor carriers. Since this type of freight constitutes a relatively small portion of the total rail tonnage and obviously presents many problems, it might appear that the railroads would have willingly let it be diverted. Such, however, is not the case. On the contrary, l.c.l. traffic once amounted to more than 10 per cent of total rail revenues

compared with 3.3 per cent in 1957, and a considerable effort has been made to recapture this business through the provision of special l.c.l. services, freight forwarding arrangements, and piggyback service. These will be discussed, together with other aspects of transportation service, in the following chapter.

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21. PHYSICAL DISTRIBUTION (Continued)

TRANSPORTATION SERVICE

General considerations with respect to service were mentioned briefly in the discussion of the various transport agencies. Obviously, airlines give the fastest service of any carrier, whereas pipelines and water carriers take the longest time to transport commodities. Trucks are usually superior to railroads in speed of service. The speed with which goods are transported, although often very important, is by no means the only service consideration of importance to shippers. Railroads in particular provide many special services including specialized types of equipment, transit privileges, and various types of l.c.l. service. Trucks and water carriers also provide specialized equipment, and motor carriers have followed the railroads to a limited extent in providing transit privileges. Nevertheless, the railroads have been the originators of most of the special services. For this reason, the following discussion will be concerned primarily with rail service.

Special Equipment

As has been mentioned previously, there are many different types of railroad cars. Four general types of closed cars may be designated: (1) those for flour, sugar, and similar items, (2) those for grain, (3) those for merchandise traffic, and (4) those for hides, brick, and similar commodities.[1] In addition, there are various types of open cars and other special cars for those commodities which cannot be loaded or carried efficiently in the regular closed boxcars. There are also various sizes of cars ranging from the standard length

[1] See Charles A. Taff, *Traffic Management: Principles and Practices*, rev. ed. (Homewood, Ill.: Irwin, 1959), p. 68.

of 40 feet, 7 inches, or less to a maximum of 50 feet, 6 inches. The trend is toward the use of larger cars and those which can be loaded and unloaded with materials handling equipment. Refrigerator cars make it possible to carry perishable products, such as fruits, vegetables, meats, and fish, from distant places of production to consuming areas. Heater cars have also been developed. Flatcars are used for piggyback service and other purposes.

Many of these special facilities were first introduced by interested shippers. This was the case especially with refrigerator cars. They were expensive and required inspection and attention at various points during shipment. Furthermore, refrigerator cars are used during only a part of the year and must go from line to line to be utilized profitably. The fear that they would not prove profitable because of this limited seasonal use, and the inability of individual railroads to control their cars when on other lines, as well as a frequent disinclination to allow cars to leave their own lines, were all important causes for the predominance of outside ownership during the early period of their use. At present the railroads own many of these special cars, but privately owned refrigerator and tank cars—the latter being used for petroleum products—are still of considerable importance.

Transit Privileges

Transit privileges of various types are widely offered by the railroads and have long been a feature of railway service. In recent years, motor carriers have followed to a limited extent the example of the rails in providing such service. Transit privileges are arrangements whereby the shipper or receiver may stop a shipment en route and reship without losing the right to pay only the through rate from the original shipping point to the final destination. Since the through rate is always considerably less than the sum of the intermediate rates, the existence of transit privileges permits a shipper to take advantage of storage and processing facilities located at intermediate points without significantly increasing his cost of transportation. Actually a small fee is customarily charged for the transit privilege, but it is a nominal cost relative to the basic transportation cost. Usually there is a limit of one year as to the time a shipment may remain in transit. The most widespread use of the transit privilege is in connection with the shipment of grain, but some type of transit privilege is available for a wide range of items, including iron and steel products, lumber and forest products, oils and oil foods, butter, eggs, coffee, agricultural implements, and many others.

There are many types of transit privileges. Among the more important are the following:

1. Storage in transit. This permits the product to be unloaded and stored at an intermediate point and then reshipped later to the final destination. A wide range of products are granted this privilege.

2. Processing in transit. This includes fabrication in transit for iron and steel products, milling in transit for the grains, and the treating and fabrication of lumber and forest products.

3. Inspection in transit. Shipments of the grains are often stopped in transit for inspection and grading. A similar transit privilege is involved in the grading and reconditioning of butter and in the grading and shelling of eggs.

4. Refining in transit. The refining, hydrogenating, and blending of corn oil, linseed oil, soybean oil, and similar products are permitted during transit.

5. Mixing in transit. This involves the mixing, blending, and converting of grains into various kinds of feed.

Transit privileges are most important in the shipment of agricultural products, but they apply to many other raw materials and semifabricated commodities as well. One motor carrier now permits dipping in transit for tire fabrics. Cities which are able to procure transit privileges are able to divert to themselves a certain amount of traffic which might otherwise not be obtained. The location of processing and storage facilities is thereby affected, as well as the development of terminal markets and wholesaling centers.

Diversion and Reconsignment

Although the terms are likely to be used interchangeably, diversion refers to changing the destination of a shipment while the car is en route whereas reconsignment involves a change of destination after the shipment has reached the destination to which it had originally been billed. Diversion and reconsignment are privileges of great importance to many shippers. Cars may be shipped in the general direction in which the commodity is to go, without deciding on a specific market at once. When a car reaches a diversion point established by the railroad, it may be sent to the specific market which the shipper then believes gives the greatest promise. Such shipments move at the through rate from original point of shipment to the final destination, as in the case of the transit privileges discussed previously. A reconsignment charge is usually made, but diversion without charge is often permitted in the case of perishables.

Although diversion and reconsignment privileges are extended to many types of products, such as grain, cotton, lumber, and coal, they are of par-

ticular importance in the marketing of perishable items, especially fresh fruits and vegetables. The demand in different markets may change while goods are en route, and to reach the best market they must be diverted from their original destination. Perishables in particular cannot be stored for long to await a more favorable price. They must be sold at once or shipped without delay to another market where better prices can be obtained. Moreover, it is frequently impossible to tell at the time of shipment whether a particular city will offer a good market by the time the product has reached it. This determination can be better made when the shipment has arrived at the diversion point. At this time, with more recent market information available, the shipper or his representative is better able to judge what city offers the best market.

Less-than-Carload Services

Because less-than-carload shipments are important to railroads and shippers alike, both parties have endeavored to improve the service and reduce the expense. The interest of the railroads in such improvement has been definitely stimulated by the competition of motor trucks, which generally are better adapted to the handling of l.c.l. freight. The railroads have experimented with many devices including package cars, pool cars, mixed carloads, pickup and delivery service, and trailer on flatcar or piggyback service. Shippers have not only utilized these railway services but have consolidated shipments through their own cooperative associations and through the use of freight forwarders. These are in addition, of course, to the use of their own motor trucks and the services of independent trucking companies.

Package Cars. Less-than-carload freight for different destinations was formerly loaded rather indiscriminately in a single car which had then to be switched to the shipping dock at each city, opened, the packages for that city pulled out, the car closed, and sent on to the next city. Car-to-car transfers were commonly necessary at junctions. An early and natural development, when sufficient traffic was involved, was to load all packages for a given destination into one car which moved directly to that point. This led to the development of merchandise or package cars operated regularly between virtually all large cities.

Under this device, l.c.l. packages to be shipped to a single destination by a number of different shippers are placed in a single car and shipped through to the destination. The dispatch of package cars may be subject to a stated minimum of receipts, but competition frequently causes the roads to send the cars whether or not the minimum is reached. Shippers are charged the

regular l.c.l. rates; but cars are commonly dispatched on regular schedules, the time of shipment is reduced, and handling is held to a minimum. The service is also of great assistance to the railroads, since it concentrates small shipments in through cars and so reduces loading and unloading costs, the cost of tranfers, and loss and damage claims.

Pool Cars. Package cars have been developed to enable individual shippers to obtain better service at l.c.l. rates. The pool car makes it possible for a single shipper who can load a car with l.c.l. freight for a number of consignees to ship it to a designated point at carload rates. At the destination his respresentative unloads the car, arranges for local delivery, and dispatches any shipments destined for other points by l.c.l. freight or motor truck.

Mixed Carloads. By a somewhat similar service the shipper of several different products, no one of which amounts to a carload in quantity, is enabled to ship them in a mixed carload at an all-commodity rate or at one which corresponds to the highest carload rate applying to any of the commodities in the shipment. This rate is usually lower than the combined l.c.l. rates would be, and the service has the further advantages of speed and reduced danger of damage and loss. Moreover, special mixed carload rates have been made for combinations frequently shipped. The mixed car privilege is advantageous to small shippers and buyers who are thus enabled to obtain the expedited service of carload shipments at rates which are lower than the l.c.l. rates charged for package car shipments.

Consolidated Shipments. Most shippers probably do not pay enough attention to the possibilities of consolidating their own l.c.l. shipments to take advantage of pool car and mixed car arrangements. It is, of course, even more difficult for two or more shippers to work together to make up a carload of freight for shipment at carload rates. Accordingly, the work of consolidating the shipments of several shippers is usually carried out by freight forwarders. The forwarder pays the carload rate to the railroad and usually collects from the shipper the l.c.l. rate of the carrier. Sometimes a lower rate can be quoted to shippers, depending upon the commodity and the services rendered by the forwarder. The principal advantage in using freight forwarders, however, is in the faster service obtained rather than in the rate charged. Consolidation to make up carload shipments results in greater speed of movement and less terminal handling and delay.

A comparatively recent development in freight consolidation is the organization of nonprofit shipper cooperatives. These associations are composed of manufacturers or retailers in a given area. They perform the function of consolidating shipments for members in order to take advantage of pool car and other arrangements. Service advantages are obtained as well as

lower rates.[2] Approximately 100 such cooperatives are in existence, some organized by shippers and some by consignees, and there are indications that the freight forwarders have lost business to these cooperatives.[3]

Pickup and Delivery Service. Regular l.c.l. service requires the shipper to deliver his freight to the railroad. The consignee must arrange and pay for its delivery from the freight station to his place of business. With pickup and delivery service these operations are performed by the railroads, who use their own trucks or contract with local cartage companies. Where such service is offered, it is usually limited to certain distances from the railroad station and may be limited to freight paying certain minimum rates. The service is optional and allowances in the form of rate reductions are made to shippers who provide for their own cartage.

Free pickup and delivery service on a limited basis dates back to the latter part of the nineteenth century, but its principal development took place during the early thirties in an effort to compete with motor carriers. Between 1936 and 1953, such service was generally available throughout the United States. Since 1953 the service has been discontinued by the railroads operating in Eastern Territory[4] and also by some other rail carriers.

Trailer on Flatcar Service

The most recent development in the effort of the railroads to compete with motor carriers, with respect to both carload and less-than-carload freight, is to haul loaded truck trailers on railroad flatcars. In this type of operation, commonly called "piggyback" service[5] but more accurately designated as "trailer on flatcar" service, a truck trailer is loaded at warehouse or factory, hauled by truck tractor to the railroad yard, placed on a flatcar, and hauled by the railroad to its destination. At destination, transfer of the trailer is again made to a truck tractor which hauls the consignment to the place or places where it is unloaded. The trailers may be owned by the railroads, by regular motor carriers, or by the shippers. The railroad may perform all the services, including pickup and delivery of the trailers, or only the line-haul service. In the latter case, pickup and delivery is performed by the motor car-

[2] See Edward W. Smykay and Irene Shiele, "Minimizing Transportation Costs with Shipper Co-operatives," *Journal of Retailing*, Summer, 1959, pp. 100–4.

[3] See "Co-ops Gain on Forwarders," *Business Week*, October 18, 1958, pp. 86 and 91.

[4] This includes generally the area east of the Mississippi River and north of the Ohio River to the Atlantic seaboard.

[5] The designation "piggyback" is apparently owned by the Piggyback Division of the General American Transportation Corporation. See *Business Week*, November 8, 1958, p. 55.

riers or by shippers. In a few instances, shippers also own and furnish the flatcars.[6]

Trailer on flatcar service was used for l.c.l. shipments as early as the twenties. Since 1953 the service has been greatly expanded as a result of certain Interstate Commerce Commission rulings and the development of larger flatcars which carry two trailers. Accordingly, the service is now widely used for carload shipments, or virtually the equivalent trailer-load. Although trailer on flatcar service still constitutes less than 2 per cent of total rail carloadings, it is growing rapidly.[7] More than two and one half times as many carloads of merchandise were hauled in this manner in 1959 than was the case in 1955. Moreover, the number of railroads offering the service is constantly increasing, equipment adaptations are being made to accommodate more and more commodities, and special trains are being provided to increase the speed of service.[8] Thus expansion of the service is expected to continue into the future, especially as new equipment becomes available. At present, the number of railroad flatcars equipped to carry trailers is somewhat limited.

The principal advantage of trailer on flatcar service lies in reduced terminal handling costs. The great advantage of the motor truck in this respect is utilized directly. No transfer of merchandise from boxcar to truck is necessary for purposes of delivery. A substantial saving in pilferage and damage claims also results from this reduced handling of the merchandise. In addition, the line-haul cost of transporting the trailers by rail is less than the comparable cost of motor truck transportation. This encourages the motor carrier, where such service is available, to transport by rail some of the traffic which it originates. In some instances, joint rail-truck rates are in effect, giving the shipper the basic advantages of truck service at a lower cost than would be possible otherwise.

STORAGE SERVICE

Storage, like transportation, is a very important function of physical distribution. Storage is the process of holding and preserving goods. The need

[6] For a good discussion of the various plans in effect, see William T. Marcoux and Celia Sperling, "Recent Developments in Transportation," *The Marketing and Transportation Situation*, October 1959, pp. 40–2.

[7] During the first six months of 1959, TOFC carloadings amounted to 1.3 per cent of total rail carloadings. This was, however, a 61 per cent increase in relation to the similar period of 1958, at a time when total carloadings rose only 13 per cent. See *Business Week*, August 15, 1959, p. 142.

[8] Although it is generally stated that some 50 major railroads offer TOFC service, a recent count ran to 94 participating roads. The Great Northern Railway operates a special pickaback express nightly between Seattle and Spokane. See *The* (Spokane) *Spokesman-Review*, April 3, 1960, p. 15. In 1959 the first shipments of new automobiles were made using TOFC service.

for storage arises fundamentally out of the lack of adjustment between the times of production and the times of consumption of goods. Its primary service is to hold goods in order to bring about this adjustment. It also performs an auxiliary service in assisting in the transfer of commodities from place to place during the marketing process.

Conditions Requiring Storage Service

The conditions which make it necessary to hold goods are of two general types, and consequently there are two principal kinds of storage service. The first of these is that which makes it possible to adjust supply and demand for products that are produced or consumed seasonally. Goods produced during a short season of the year must be held over if they are to be consumed in other seasons. This is the situation with most agricultural products. Frozen fruits and vegetables, butter, grain, cotton, wool, and tobacco, for example, are stored for varying periods of time. Another example of seasonal adjustment is iron ore from the Lake Superior district, which is accumulated near the steel mills in the Chicago and Gary district in large quantities during the summer. None can be shipped on the lakes after the close of transportation in the fall. Coal likewise is shipped on the Great Lakes to northern ports to be stored for winter use.

This type of storage service is also required when there is lack of adjustment because of seasonal consumption. This occurs when goods which are consumed in large volume during short seasons are produced throughout the year or at least over long periods, a condition which arises in many manufacturing industries. Christmas toys and decorations, for example, must be stored until the Christmas selling season. Many other products, although consumed throughout the year, are purchased by consumers in larger amounts during certain seasons. Common examples of these are clothing, sporting goods, automobiles, and building materials.

The second type of storage service is that which is required to hold goods over a short period of time as they move through manufacturing and distribution channels. Both manufacturers and middlemen must store surplus supplies and merchandise. There are many reasons for this: to take advantage of quantity prices in purchasing and of carload rates for transportation, to guard against delayed shipments, to have enough merchandise on hand to meet variations in demand from day to day and from week to week, and to have a variety of stocks from which buyers can select. Many manufacturers find it necessary to keep goods constantly available at many distribution points throughout the country. In order to do this, someone must perform the warehousing function. At times, temporary market conditions will require

that goods be held for a longer period than originally contemplated. When this is necessary, additional warehousing facilities may have to be obtained.

In addition, storage is essential to the effective performance of other marketing functions. Goods may be stored until enough have been collected to make up a truckload, carload, or boatload. Goods in storage may be exhibited to buyers, and they may be inspected, graded, conditioned, cleaned, mixed, and packaged by warehousemen. Stored goods may serve as collateral for loans. Finally, placing goods in storage may be a temporary expedient to remove them from the market in order to achieve price stabilization.[9]

Types of Storage Service

Storage is carried on both as an adjunct to private business and as a public service enterprise. Factories, wholesale middlemen, and retailers commonly have their own storage space in which to warehouse the goods they use or sell, but they also make wide use of public warehouse space. Agricultural products on reaching the market, whether they are used for final consumption or as raw materials for manufacture, are usually stored in public warehouses owned and operated by private companies for the express purpose of providing storage space for others. Public warehouses are usually located in important trade centers, and they render a variety of services for their clients. Since there are several distinct types, it is desirable to discuss at greater length the special features of public warehouses. It should be held in mind, however, that the bulk of the total warehouse space available for the storage of goods is operated by manufacturers, wholesalers, and retailers for their own use.

Public Warehouses. In 1958 there were approximately 8,500 establishments in the United States offering public warehouse service.[10] More than half of these consisted of household goods warehouses and food locker plants, which serve the general consuming public rather than the businessman engaged in the marketing of goods and thus need not be discussed here. The remaining types—farm products warehouses, refrigerated warehouses, and general merchandise warehouses—are all of considerable importance to the present discussion.

Special Commodity Warehouses. Some warehouses are designed for the storage of a specific commodity only. These are usually designated as special commodity warehouses. Included in this type are those facilities designated

[9] The relationship of storage to prices will be discussed further at a later point in the chapter.

[10] According to the *U.S. Census of Business: 1958, Public Warehousing,* Preliminary Report (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census, 1960), p. 1.

by the Census as "farm products warehouses" and "special warehouse and storage facilities," a total of 1,915 establishments. Cotton warehouses are the most important segment of this class, constituting almost one half of the establishments and obtaining more than half of the revenue of all commodity warehouses. Grain elevators rank next in importance. Other types of farm products warehouses include facilities for the storage of tobacco, wool, potatoes, and other similar items. Other special products facilities include fur warehouses and storage tanks for bulk petroleum products and other bulk liquids, such as vegetable oils.

Special commodity warehouses often perform other marketing services in connection with the storage function. These include inspection, grading, conditioning, and others previously mentioned. Cotton is often compressed while in the warehouse. Grain is inspected and graded. Auction sales are conducted by tobacco warehouses. Cleaning and mixing operations are also common. Some products may even undergo basic processing while in storage.

Refrigerated Warehouses. Although refrigerated warehouses are relatively few in number, they perform an important storage service with respect to perishable food products. About half of the available space is in warehouses equipped to handle a variety of products. The remainder is in warehouses that specialize in certain products, such as apples, eggs, poultry, and similar items. Most of the refrigerated space is used for fresh and frozen fruits and vegetables, for butter, cheese, and other dairy products, and for poultry and fresh meats. These are all products which are highly perishable when exposed to varying temperatures in ordinary storage, but which can be held for relatively long periods in cold storage without serious deterioration or impairment. Thus they can be placed in storage during the season of peak production and then fed to the market in the more regular stream that consumer use demands. In this way, prices are stabilized, production is encouraged during the regular season, and large marketings need not be so greatly discounted as would otherwise be the case. For some products, especially poultry and eggs, production now takes place under conditions which permit a regular and steady output. Refrigerated storage is thus of considerably less importance than formerly for some items but is still important for many food products.

General Merchandise Warehouses.[11] About 1,500 general, or public, merchandise warehouses offer storage and other distribution services for virtually any item that does not require special facilities.[12] Manufactured and semimanufactured goods make up a large part of the business of the general

[11] For a more detailed discussion, see John H. Frederick, *Using Public Warehouses* (Philadelphia: Chilton, 1957).

[12] Some general merchandise warehouses maintain special facilities, usually to a limited extent. For example, a certain amount of refrigerated space is available in some general warehouses. Others maintain storage facilities for household goods.

merchandise warehouse, but some raw materials are also stored. Manufacturers, wholesalers, and retailers constitute the users of general merchandise warehouse facilities.

General warehousemen render many distribution services in addition to the basic one of storage. Pool cars and other consolidated shipments may be consigned to them for distribution and reshipment. They break down bulk shipments and large packages into smaller quantities. They load and unload freight cars and trucks for the owner of the goods. They handle orders for manufacturers and arrange for delivery of the merchandise to buyers.

Wholesalers and retailers most often use general merchandise warehouses for the storage of surplus stocks at times when inventories are unusually large and their own space is completely filled. Manufacturers may also use merchandise warehouses in the same way and for the same reason. But some manufacturers use the merchandise warehouse as a distribution agent in preference to maintaining their own facilities. Spot stocks are kept in warehouses at certain strategic locations. When orders are obtained by the salesmen of the manufacturer, they are sent directly to the warehouseman to be filled. The latter has a list of accredited customers to whom shipments may be made without further checking with the manufacturer. Thus orders are filled quickly from stocks that are maintained close to the market. The manufacturer pays only for the services rendered by the warehouseman and does not incur the overhead cost of maintaining his own branch distribution center. This is particularly economical for manufacturers who do not have a sufficient volume of sales in the area to warrant the establishment of such a branch.

Bonded Warehouses. A bonded warehouse is not a special type of warehouse, according to the above classification, but is a warehouse which has taken out a bond to assure payment to the United States Treasury of certain taxes or import duties due on stored commodities.[18] An Internal Revenue bonded warehouse handles goods, principally tobacco products and alcoholic beverages, which are produced domestically and which are subject to substantial excise taxes. Both tobacco and alcoholic beverages are aged for a considerable period of time. If the excise taxes on these products had to be paid at the beginning of the storage period, the manufacturer would have a prohibitive sum of money invested in the products for a long time. Storage of the products in a bonded warehouse permits the deferment of tax payments

[18] Some state laws require public warehouses to file a bond or a legal liability insurance policy as a protection to the users of their services. Also, under the United States Warehouse Act of 1916, some commodity warehouses are licensed by the U.S. Department of Agriculture to issue federal warehouse receipts. Such warehouses are also required to file a bond. These are not, however, bonded warehouses as the term is used here.

until the products are withdrawn for distribution through normal trade channels. To assure payment of the taxes prior to withdrawal of the commodities, the warehouse is placed under bond to the Treasury Department and a government custodian is designated. The products cannot be withdrawn from storage until this latter official has signed a release.

A similar type of arrangement is made through the Customs bonded warehouse for imported commodities subject to an import duty. The goods may be stored under bond without payment of the duty until the importer has arranged for their sale. At that time, the duty is paid and the goods are released to the warehouseman who in turn releases them to the owner. As in the case of liquor and tobacco, the owner need not have a large sum of money tied up in tax payments pending final sale of the merchandise.

Not all bonded warehouses are public warehouses. Distillers and tobacco manufacturers in particular often operate their own private bonded warehouses. Moreover, there is usually a limit as to the time that products may remain in storage under bond. For example, until 1958 the limit for alcoholic beverages was eight years. At the end of that period, the tax had to be paid regardless of whether the product was withdrawn from storage. In 1958, however, the time limit was extended to 20 years in view of the large amount of whiskey which was being stored under bond at that time and which was approaching the eight-year time limit with little prospect of profitable sale.

Characteristics of Adequate Storage Facilities

The storage of goods can be efficiently accomplished only when storage facilities meet certain requirements. Goods must be properly cared for, they must be stored at convenient points, and storage operations must be so controlled as to protect the interests of all concerned.

Care of Merchandise in Storage. Goods in storage must be preserved as nearly as possible in their original condition. Protection from theft, fire, wind, water, heat, cold, insects, animals, and from natural deterioration is essential. The physical condition of the goods must be determined by inspection on arrival and on delivery, as well as from time to time during storage. Satisfactory warehousing of perishable foodstuffs commonly calls for the installation of special equipment to provide refrigeration in warm weather and heat in cold weather. The proper storage of grain may involve the provision of special machinery for cleaning and conditioning—to keep it from heating in the bin, for example, or from spoiling from the collection of too much moisture. Some products need special care and treatment in storage in order to

condition them for use. Lumber is seasoned; meats, cheese, tobacco, and hides are cured; bananas, tomatoes, and some other foods are harvested green and put into storage for ripening. These processes may, of course, be considered as production rather than marketing, but they are usually carried on as a part of the storage service and require special storage facilities.

Location of Storage Facilities. The selection of proper places for storage is of considerable importance to effective marketing. Facilities must be placed so as to meet the needs of the prime producer, middleman, manufacturer, and final consumer; and they must be located so as to expedite transportation and financing. Goods en route from the place of production to the centers of manufacture and consumption are stored at points near transportation facilities, and they must also be stored, so far as possible, near the markets in which they are bought and sold, near the factories in which they are processed, and near the financial agencies which provide the funds invested in them. In order to meet these requirements, surplus supplies are stored in warehouses close to the large commercial centers where the means of transport, exchange, and finance are concentrated, and in which manufacturing tends to center.

The concentration of storage in central markets is further accentuated because the inspection and supervision of warehouses are important to the proper care of products which are to be used as the basis for loans or which are sold by sample. This is more effectively accomplished on a large scale, and the best results are often obtained when the products are held near to the agencies most directly involved. Supplies for consumption and manufacture can be quickly secured from central markets and so the need for storing in large quantities close to the consumer has been minimized. The economics of transportation and distribution in large amounts make it desirable, nevertheless, to locate warehouse facilities where merchants who buy in large amounts are located. There is, consequently, a further need for storage facilities at those points outside the central markets at which wholesalers, manufacturers' branch houses, and transfer points for dispersion to retail stores and to manufacturers are found. Finally, storage commonly involves physical equipment and mechanical devices which are operated economically only when a considerable volume is stored in one place.

Control of Storage Facilities. Adequate control of warehousing implies that warehouses shall be operated by firms which are reliable and can be depended upon for the proper performance of the storage function. Title to the goods must rest clearly and certainly in the proper hands. Salable goods, in the last analysis, are the security for the funds invested, but they are of little value as security unless the title to them is clearly in the hands of the

proper party. Title is usually given by a warehouse receipt representing the goods stored. And the safety of the invested funds is not properly insured unless this receipt gives a clear title to the goods to the holder of the receipt. It was in large part to make this title secure that the United States Warehouse Act was passed in 1916, and it is with this in view that uniform warehouse receipts laws have been passed in the states, so that banks and other interested parties can be certain of the status of the security for the loans they make.[14] It is for this reason that the Federal Reserve Board, the American Bankers Association, commodity exchanges, and the state and federal governments have all interested themselves in the control of warehouse receipts.

It is often necessary that the value of stored commodities on which loans are made shall be accurately determined. As a result, the quality and grade must be known in order that their market value can be ascertained. For this purpose agricultural products in particular must be carefully inspected when they are placed in and taken out of storage, in order to determine the warehouseman's responsibility for their condition and quality. Federal, state, and municipal governments and commodity exchanges all have taken a hand in controlling and providing such inspection services. In many cases inspection certificates when issued are legal evidence of the quality of the goods at the time of the inspection. If in addition to this the goods have been sold for future delivery, or if their future price has been assured through hedging,[15] their value as security for a loan is enhanced. Here again the necessity for proper storage is important, so that the quality of the goods may be maintained until the loan is paid off.

The control of public warehouses is especially important to the financing of marketing, since a large part of the stocks of raw materials and foods and an appreciable part of the supplies of manufactured goods are stored by independent warehouse concerns. The owners of goods are frequently unable to supply their own storage space, and furthermore the service is often better rendered and more cheaply supplied when carried out on a large scale by independent specialized agencies. In the grain trade, for example, the terminal elevators are often licensed and controlled by the local exchange as well as by the state or federal government. For when grain is sold for future delivery, contracts are met by the delivery of warehouse receipts, and successful trading necessitates confidence in these receipts. The rates charged and the service rendered by public warehouses are commonly regulated by the state much as are public utility rates and service. This is done mainly to avoid discrimination among users.

[14] See John H. Frederick, *op.cit.*, Chaps. 12, 13, and 14.
[15] See Chap. 23 for an explanation of hedging.

Storage and Other Marketing Activities

It is evident from the previous discussion that the effectiveness with which the storage function is performed determines in part the successful performance of other marketing functions. The availability of storage service permits manufacturers and middlemen more flexibility in their buying and selling activities and in their choice of transportation service. Inspection and grading, phases of the standardization function, are often carried out by warehousemen while the products are in their possession. And proper storage reduces the risk of physical deterioration of goods. There are two aspects of storage service, however, that are of sufficient importance to warrant further discussion. These are the relationship of storage to the financing of goods and the use of storage to reduce the risks of price fluctuations.

Finance and Storage. The volume in which goods are stored and the length of time over which many are held give rise to some of the most difficult problems of market finance. During the entire time that goods are in storage, funds are invested in them. These funds may be supplied by the producer, middleman, financial agency, manufacturer, or consumer. But whoever supplies them must face the possible loss of his investment, because the goods may deteriorate in quality, may be stolen, or may lose value in a falling market. Because of the importance of this aspect of storage, great attention is commonly paid to the relationship between warehousing and finance.

Warehousemen sometimes serve as financial middlemen as well as storage agents, either through advancing funds directly, or by assisting the owner in borrowing from financial houses. The stored goods are often the security for loans made by banks or for the credit allowed by supply houses. To expedite financing, the warehouse receipt has been developed to a high degree of usefulness by associative activity and by law, until it is now in many trades the basic security involved in financing goods. Warehouse receipts may be either negotiable or nonnegotiable. In either case, they constitute the evidence that certain designated goods have been deposited with the warehouseman. These receipts may then be assigned or endorsed to a bank as security for a loan on the merchandise involved. When the goods are sold, the loan is paid off and the warehouse receipt returned to the original owner who can then remove the goods from storage and deliver them to the buyer.

Field Warehousing. The importance in financing of the warehouse receipt issued by a public warehouseman is further emphasized by the development of field warehousing. Under this plan products are held in storage on the owner's premises, but the warehouse space is leased by a public warehouseman

who has physical and legal control of the goods. He allows no access to them except under prescribed conditions, and issues warehouse receipts to the owner which are used for making loans based on the value of the commodity. Thus the space becomes in effect a branch of the public warehouse. This is primarily a financial arrangement which enables the owner of goods to use them as collateral for loans. But for this device, he would need to place them in a regular public warehouse before a loan could be made. This would necessitate transportation to the warehouse, and the owner would be required to pay for the storage space; whereas he may have space of his own which can just as well be used. This method is now widely used by manufacturers, producers of raw materials, and middlemen. There are several large field warehousing organizations which specialize in this type of arrangement. But any regular public warehouseman can engage in the practice so long as a way can be devised for him to take actual and exclusive possession of the property.

Storage and Prices. Storage has an important effect on prices. By making it possible to hold products over from periods of surplus production so that they may be consumed uniformly throughout the year, it assists in the adjustment of supplies to the needs of consumers and thereby exerts an influence in stabilizing prices throughout the year. When surplus supplies are kept off the market, prices are maintained during periods of abundance. Consumers must, therefore, pay higher prices; but, in turn, they pay less when the stored products are sold during the period of scarcity. Again, since stored goods can be used as the basis for loans, it is possible for those who produce goods which are consumed seasonally to use the produced goods as security for loans, and they are thereby enabled to produce more uniformly throughout the year. This permits manufacturers to smooth out production peaks, and so results in improved production and reduced costs. Temporary gluts, particularly of agricultural commodities, as well as temporary shortages, can be avoided because goods can be stored and need not be sold as soon as they are produced. The net effect then of storage is to make prices and consumption more uniform throughout the year. This, likewise, results in larger production and consumption of seasonal goods, for consumers are given a longer time in which to consume, and out-of-season prices do not rise so high as they otherwise would. Moreover, producers can bring larger total supplies on the market over a period of time because they do not need to be "dumped" during the short season of production. Since the surplus can be held over for later sale, prices are higher during the season and losses from dumping can be avoided. Even highly perishable commodities can be held in storage for a few days or hours to reduce or prevent loss from immediate sale on a glutted market.

Other economies from storage that have a direct or indirect effect on prices through reducing marketing costs have already been pointed out. Transportation costs are often reduced. Carlots can be sent to the warehouses of manufacturers and middlemen, or to public warehouses, from which they can be distributed to local users. Since the rates for carload lots and for through shipments are commonly lower than for smaller shipments, this reduces the amount of expensive small-lot transport that would otherwise be necessary. And because local deliveries from nearby warehouses are quickly made, the stocks of small-lot buyers can be reduced. Finally, operating on a large scale and carrying many products, public warehouses can often operate more cheaply than could private warehouses operated by the individual businessmen who use their services.

MANAGEMENT OF THE PHYSICAL DISTRIBUTION FUNCTION

As indicated at the beginning of the previous chapter, manufacturers and middlemen are paying more and more attention to the problems of physical distribution.[16] Some firms have even established a physical distribution department with a manager of equal rank in the organization to that of the marketing manager and the manufacturing manager. In most cases, however, the department is operated as a staff department responsible to the marketing manager.

The function of the physical distribution department is to take charge of the products from the time the manufacturing process is completed until the goods are delivered to buyers. The department is responsible not only for transportation and warehousing but also for inventory control of finished goods, for order processing and handling, for billing, and for all phases of customer service. The physical distribution department works with other departments on the technical aspects of package and carton design, especially as such design affects transportation and warehousing costs. It works also with the manufacturing or production department on production planning and scheduling, particularly with respect to economical production runs and the balancing of lower manufacturing costs against higher storage and financing costs when runs are increased. Modern physical distribution, then, encompasses a variety of activities previously scattered throughout the organization. It has been described, in military terms, as the logistical arm of the

[16] See, for example, Richard S. Denenholz, "Physical Distribution as a New Staff Function in Marketing," in Frank M. Bass (ed.), *The Frontiers of Marketing Thought and Science*, Proceedings of the December 1957 Conference (Chicago: American Marketing Association, 1958), pp. 95–101; and *Business Week*, November 14, 1959, pp. 108–10 and 114.

marketing organization, supporting the strategy and tactics of the regular marketing organization and bearing the responsibility for delivering the right products to the right places at the right times in the right amounts.[17] To this we might add the phrase "at the lowest possible cost" consistent, of course, with good service.

The modern emphasis on physical distribution has been brought about, in fact, by the desire to reduce costs as well as by the need to increase efficiency and improve customer service. Transportation and storage costs constitute a substantial portion of the total cost of marketing many products, and such costs have risen appreciably since World War II. In the effort to control these costs, management has found it necessary to pay more attention to the various alternatives available for the physical distribution of its products and to engage in a greater amount of planning for such distribution. Obviously, transportation costs and warehousing costs must be balanced against each other to determine the lowest cost combination, e.g., whether to ship small amounts at high freight rates and reduce or eliminate warehousing costs or ship carload lots at low rates with the result that storage costs are increased. In addition, it has been discovered that there are many savings to be made in general inventory control and in order handling costs, areas of control that have been largely neglected in the past.

In addition to the cost considerations mentioned, there have been many new developments in materials handling equipment and in data processing equipment. Properly used, these machines can improve efficiency and provide greater control over operations. But, to achieve these advantages, it may be necessary to revise the traditional organizational structure so that all phases of physical distribution will be closely coordinated. If proper planning and coordination are obtained, not only will efficiency be improved but the customer will receive better service. And this is the primary objective of the entire marketing operation.

The result of this greater emphasis on physical distribution, in consumer goods lines at least, appears to be the development of large distribution centers both by manufacturers and by chain retail organizations. These large centers have replaced to a certain extent the more numerous branch warehouses that previously existed. In the case of manufacturers, the centers have also taken over the function of finished goods storage previously performed at the plant. Thus, as soon as the goods are produced, they are shipped to the distribution warehouses in carload lots. Here modern equipment and warehouse facilities are available for economical handling and storage. Inventory control is established through the use of data processing equipment at cen-

[17] Richard S. Denenholz, *op.cit.*, pp. 96–7.

tral locations so that exact knowledge is always at hand regarding availability of stocks at all distribution warehouses. Data processing facilities are also used to process and handle orders, to check credit ratings of customers, and to take care of invoicing and billing. Orders are filled promptly by the distribution warehouses, using in many cases special transportation facilities such as contract truck carriers or piggyback trains on expedited schedules. The result is lower costs, increased efficiency, and better service. Moreover, the field sales offices can concentrate their efforts on selling without being concerned with warehousing and order filling, as they once were.

With increasing frequency, business firms are using mathematical programing to solve some of the problems of physical distribution. Through the use of mathematical and statistical techniques, including linear programing and other methods of operations research, it is possible to handle management problems involving a large number of numerical values. Mathematical models and formulas can be devised which will solve many of these problems.[18] For example, a company with a dozen factories and several hundred customers finds it very burdensome and time consuming to determine the best and lowest cost transportation pattern using nonmathematical methods. Through mathematical programing, however, the "best" solution can be obtained more accurately and economically.

In the area of physical distribution, mathematical programing has been used successfully, for example, to choose the best location for a new warehouse, to distribute customer orders among existing warehouses in such a way that transportation delays and costs will be minimized, and to establish lot sizes for purchased or produced goods which will minimize the combined costs of acquiring and holding inventories. The success of mathematical programing in the field of physical distribution is leading to further development in the construction of operationally useful mathematical models that simulate the behavior of consumers and competitors and that allocate resources to the various types of selling effort. In all of these applications, it is usually desirable to work out the problems with the assistance of electronic computers—which can then also be used for inventory control and in the other ways previously mentioned.

This brief discussion indicates something of the importance of the functions of physical distribution, including transportation and storage which have been considered at greater length. Previous chapters have been concerned with the functions of exchange, selling and buying, which constitute

[18] See Alexander Henderson and Robert Schlaifer, "Mathematical Programing," *Harvard Business Review*, May–June 1954, pp. 73–100; and C. West Churchman, Russell L. Ackoff, and E. Leonard Arnoff, *Introduction to Operations Research* (New York: Wiley, 1957).

the heart of marketing. The four following chapters will consider the facilitating functions—financing, risk-taking, obtaining and utilizing market information, and standardization—which are also very important aspects of the marketing process.

QUESTIONS AND PROBLEMS

1. Using as a basis the organization chart shown in Figure 18-1 on p. 383, indicate the changes that would be necessary to establish the physical distribution function on the organizational level suggested in this chapter.
2. Consider the question of whether the physical distribution manager should be subordinate to the marketing manager or hold a position of equal authority and responsibility. What are the advantages and disadvantages of each possibility?
3. Draw a revised organization chart showing a physical distribution manager and a marketing manager on the same plane of authority and responsibility. Include under the physical distribution manager the various subdivisions that normally and logically belong there.

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22. MARKET FINANCE

The problems of market finance have to do with supplying the funds necessary for the performance of the marketing functions. In particular, funds are needed by business firms to finance the holding of stocks of merchandise and to meet the costs of buying and selling. In addition, credit is often extended to the ultimate consumer for the purchase of goods, and funds must be available to finance such credit extensions. Thus the function of market finance involves two principal aspects or problems: (1) the financing of business enterprise, and (2) the financing of consumers.

FINANCING BUSINESS

The funds used by business are obtained by permanent investment and by means of current or short-term financing. The former includes the permanent investment made by the owners of business enterprises engaged in marketing activities, such as the investment of individual businessmen or of stockholders, and long-term loans such as are effected through the sale of bond issues. The latter includes funds borrowed on a short-term basis and credit arrangements for the purchase of merchandise. The present discussion will be concerned primarily with this latter type, that is, with the financing of current expenses involved in the production, purchase, and sale of merchandise, and for carrying stocks. The problems of current financing for the purchase of materials, equipment, and supplies used for production cannot be clearly differentiated from those involved in meeting the expenses of marketing. But since the need for such financing arises primarily out of market conditions, it may be considered an integral part of the present discussion.

Conditions Determining Current Financial Needs

The amount of funds required for current financing depends upon a number of factors. All business firms have certain normal working capital

requirements which often are met either through invested funds or through some relatively permanent source of capital such as long-term borrowing. In addition, most lines of business have certain "peak" seasons during which current funds are needed in unusually large amounts. This is especially true with respect to agricultural products, which must be stored and financed from the time of production to the time of consumption. The peak season is found also in the production and sale of automobiles and other durable consumer goods, in the construction industry, in men's and women's clothing, and in fact to some degree in virtually all lines of business. Additional funds are also normally required to finance goods during certain peak selling seasons, such as Christmas and Easter. Finally, most business firms have temporary needs for additional working capital from time to time for other reasons. Temporary peaks and valleys in the volume of sales being obtained affect current needs for funds. Cyclical changes in business affect not only sales volume but also the collection of receivables. These and other factors relating to market conditions determine at any given time the amount of current financing required.

Normal Working Capital Requirements. Business firms vary greatly in the amount of funds needed to meet normal working capital requirements. These variations depend basically upon the conditions of production and marketing in specific industries and upon the efficiency with which a specific business enterprise is conducted. Among the factors which are important in determining normal working capital needs are the following: (1) the unit costs of production and marketing, (2) the length of the production and marketing cycle, (3) the quantity and variety of stocks that must be carried to meet demand, (4) the accuracy with which the market is anticipated and production, purchases, and sales are correlated, and (5) the terms of payment offered and received. Each of these factors will be explained briefly in the following discussion.

Costs of Production and Marketing. Industries in which raw materials are expensive, which require costly processing of these materials, or which involve high marketing costs for the finished products need larger amounts of working capital per unit of production than do industries in which the reverse conditions exist. Automobiles and other consumer durables of high unit value constitute good examples. Not only must manufacturers finance the production and purchase of numerous parts and subassemblies, but in addition capital must be available from some source to pay transportation and other marketing charges incurred by the products prior to final sale to ultimate consumers. As a result, the financing of inventories and floor stocks at both the manufacturer and dealer levels constitutes a major problem,

which at certain levels of distribution has been taken over by specialized financing agencies. Even with these special financing arrangements, however, it is still necessary for dealers in some of these products to maintain large amounts of invested funds for working capital purposes.

Length of the Production and Marketing Cycle. The length of time that goods are in preparation for the market—that is, in the process of manufacture, in storage, in transportation, and in other phases of the marketing process—is very important in determining normal working capital requirements. Obviously, if goods are long in process, the investment in the materials being processed will be large in relation to the current output. In some industries, as in the manufacture of iron and steel and the products made from them—ships, locomotives, buildings, bridges—goods are in process or in storage between processes for months and often for years before they are in the form in which final consumption takes place. In the clothing industry, because of the time involved in production, large stocks ready for market or near the final stages of production must be kept in reserve to meet the possible demand. These conditions reduce turnover and increase the necessary working capital and the cost of financing. In other industries, however, processing is completed in a few days and shipments to buyers made almost immediately, thus keeping at a minimum the amount of working capital required.

Quantity and Variety of Stocks Required. Another important factor affecting the financial requirements of a business is the amount of finished goods, materials, and supplies that must be kept on hand to accommodate fluctuations in demand for the product and in the receipt of materials and supplies. When a large inventory must be maintained, a considerable investment in stocks is necessary. This condition arises when supplies are uncertain and irregular in arrival or when they must be transported from a distance. Again, if the plant is located far from a portion of the market for its product, or if wholesalers and retailers order in small quantities relative to sales, large inventories of finished goods must be maintained and financed at the factory or at strategically located warehouses. When these large stocks are held by middlemen, of course, the burden is simply shifted or divided; the fundamental situation is not altered.

Some goods must be produced in a variety of types, sizes, and colors. The greater the variety of products and models the larger are the inventories that must be carried by manufacturer and middleman in order that they may be certain of having in stock whatever the consumer desires. And carrying these inventories requires additional funds. Some firms in the paint industry have solved rather well the problem of furnishing a variety of colors, especially for interior use, without a substantial increase in inventories, by shift-

ing some of the processing to the retail dealers. The base and the pigment are sold separately and the dealer mixes the paint for the consumer. A variety of pigments must be stocked, of course, but the same base can be used for various colors and these stocks can be maintained at much lower levels than would otherwise be possible. For most products, however, such an arrangement is not feasible, and investments in stocks continually increase at all levels of distribution as greater and greater varieties of products are made available to consumers in our modern economy.

Correlation of Production and Purchases with Sales. The accuracy with which production, purchases, and sales are correlated is also an important factor in determining the amount of working capital required. A close correlation between production or the purchase of merchandise on the one hand and the sale of goods on the other is more easily obtained in some industries than in others. For example, the demand for staple goods is likely to be more regular and less subject to unforeseen fluctuations than is the demand for fashion merchandise. Thus the market for the former can be anticipated more exactly than it can be for the latter, and production and purchases can be more closely correlated with sales. Nevertheless, the success with which this is done is likely to be as much a matter of managerial efficiency within the particular firm as it is to depend upon the type of merchandise involved. The accuracy with which demand is anticipated and the effectiveness with which the goods are sold determine the relationship of stocks to sales and thus the rate of stock turnover. And rates of stock turnover may vary greatly among firms operating in the same line of business. In any event, the higher the rate of stock turnover the less is the investment in merchandise and the cost of financing that investment.[1]

Terms of Payment. The terms of purchase and sale affect the need for working capital. When the manufacturer or middleman pays cash for his purchases of materials or merchandise but extends credit to those who purchase the final product, he must have funds with which to finance these transactions. Thus it is not uncommon for wholesale merchants to pay cash within 10 days, carry the goods in their warehouses until they are sold, and extend credit to the retailers and other buyers to whom they sell. At the other extreme is the manufacturer who is given credit for his supplies and has his working capital advanced by purchasers. In his case direct financing is at a minimum. Again, the length of time for which credit is extended to customers affects the volume of current financing. It may be further influenced by the extent to which cash discounts are offered and taken.

[1] There are, of course, disadvantages to too high a rate of stock turnover. See the discussion in Chap. 19.

Terms of sale vary a great deal from industry to industry. In a number of lines, terms are quoted of "2 per cent 10 days, net 30." This means that if the bill is paid within 10 days after the date of the invoice a cash discount of 2 per cent is allowed from the face amount, and that in any case the full amount must be paid at the expiration of 30 days. If the cash discount privilege is generally exercised by the buyers, and it obviously should be since the effective rate of interest involved is some 36 per cent, the seller requires less working capital than is needed in situations where the buyers delay payment until the final due date or even later.

There are other lines of business in which the terms of sale are both more restrictive and less restrictive than the 2/10, net 30 terms. Many grocery wholesalers now sell only for cash on delivery and thus reduce their own financing needs to a minimum. In other lines, however, such as dry goods and ready-to-wear, textbooks, and house furnishings, longer terms are often granted through the use of extra and season datings. Thus terms of 2/10, 60 extra are rather common in the dry goods field, meaning that the retailer has 70 days in which to take the cash discount and 90 days for the net period. Textbooks sold and delivered to book stores during August and September are usually invoiced at some such date as October 15, thus giving the retailer an opportunity to sell the stock before payment must be made. In both of these examples, the manufacturer or publisher must maintain relatively large amounts of working capital because of the lengthy terms of sale offered.

Seasonal Fluctuations in Financial Needs. The problems of financing seasonal peaks are of particular interest to students of marketing because such problems are due largely to market conditions. If sales are seasonal and production involves a considerable period of time, stocks of goods must be manufactured and held ready for market long before they will be bought by final consumers. On the other hand, if production is seasonal, stocks must be held for later consumption. These conditions can be illustrated from well-known industries.

Since the production of cotton and wool is seasonal, stocks must be held throughout the year for the use of the textile mills. The sale of clothing is also seasonal, and consequently much of the finished product must be produced well in advance of the time of final sale. The seasonal production of lumber and the seasonal sale of automobiles and other consumer durable goods are further illustrations. The canning of salmon and of fruits and vegetables and the manufacture of sugar illustrate industries in which the goods are not long in process, but in which the production of the raw material is seasonal. Since the raw materials are perishable, such commodities are held in the form of finished products and are stored by manufacturers and middle-

men. In the case of flour, the grain is held and milling is carried on more or less uniformly throughout the year. Obviously, these and other seasonal industries require at certain periods of the year additional current funds, often rather substantial amounts. These funds are usually provided through short-term loans.

Other Temporary Needs. There are also times when particular temporary conditions, not of a recurring seasonal character, make additional funds necessary. There are numerous reasons for this situation, but in general they are tied to the changes that take place in business conditions. During periods of general prosperity and peak demand, additional working capital may be necessary to finance increased production and the costs of marketing these additional products. When prices are rising rapidly, more funds are required to finance investments in raw materials inventories and stocks of finished goods. Major changes in fashion and the introduction of new products generally also call for abnormally large current expenditures of a temporary nature.

Adverse changes in business conditions are as likely to lead to a need for additional funds, at least for a time, as are favorable changes. When sales decline, existing stocks of finished goods must be held for a longer period than previously anticipated. At the same time, that merchandise which is sold may not be paid for promptly. During recession periods, there is a tendency for payments on accounts receivable to be "slow" with a resulting need for more working capital on the part of the creditors. Eventually, of course, adjustments are made to the new situation: production and purchases are curtailed, credit risks tend to be selected more carefully, and the need for current funds is reduced.

Conclusions. It is a principle of good management that the investment in inventories shall be as small as is consistent with the needs of the business. The stock of raw materials and supplies which the manufacturing plant has on hand or en route to its factory should be no larger than the immediate needs of the plant require, and its supply of finished products should not be in excess of the immediate needs of its market. The stock of the middleman should be no larger than service to his customers necessitates. The ideal would be for the raw materials to flow into the factory in just sufficient quantities to meet the needs of processing, and for processing to proceed so as to turn out finished goods in exactly the quantities immediately demanded in the market. With the middleman, the ideal would be for goods to come into the warehouse just in time to be put into proper condition for immediate sale. These ideals are, however, impossible of achievement.

For the going concern, the actual amount of current funds needed is determined primarily by market conditions. If the market is not seasonal, this

amount will be relatively constant. For after the product begins to reach the market, there will be a steady flow of products out of the factory and a flow of income into the treasury. This will offset the steady payments for materials, supplies, labor, advertising, and other current expenses. Such a condition with income balancing outgo is, however, seldom realized, and the industries are few indeed in which there are no problems of seasonal finance. Even with these fortunate industries many problems of current finance arise. For general business conditions affect the volume of sales, payments may be slowed up with a retardation of general business, prices vary from time to time, and deliveries of raw materials are irregular. These and many other considerations make it impossible to depend upon current income always to meet current outgo.

Methods of Financing and Sources of Funds

The funds with which to meet the needs previously outlined may be supplied in several ways: (1) by the use of invested capital and long-term borrowing, (2) through short-term borrowing from banks and similar financial institutions, (3) through the use of factors and other types of accounts receivable financing, and (4) by postponing payment through the use of open account credit.

Financing through Permanent Investment. A certain amount of long-term financing is required, of course, for every business. The invested capital of the owners and long-term borrowing are the basis of such financing, the proceeds being used to purchase buildings and equipment that will be utilized over a period of time. In addition, a certain amount of permanent working capital is also obtained from these sources, although many firms depend upon short-term bank loans and credit extension by suppliers for much of their normal working capital.

Although having a large proportion of invested funds does give stability and security, this is not necessarily the best policy to follow in financing a given business enterprise. Since working capital requirements do fluctuate to a certain extent, there is always the possibility of having idle funds which at best, when not in use in the business, can be loaned with safety only at low rates of interest. But even for normal and relatively permanent working capital needs, it may be more profitable to rely on borrowing, often of a long-term nature, rather than on invested capital. The firm which can earn 10 per cent, say, on the capital it employs, while paying interest of only 5 or 6 per cent on borrowed funds, obviously is in a position to profit from

borrowing—provided that it can do so without too great a risk of losing control of the business.

The problems of long-term financing, however, are not of great importance to the present discussion. It is sufficient to note that some working capital needs are often supplied through permanent investment and long-term borrowing. The function of market finance is more properly concerned with the problems of short-term credit: bank loans, accounts receivable financing, and credit extension.

Bank Loans. Temporary demands for current funds can often be satisfied through the use of short-term bank loans. This is likely to be the source of funds utilized to finance the seasonal peaks of business and to carry unusually large inventories or accounts receivable. Although such loans are usually made for relatively short periods of time, e.g., 30 to 90 days, they can often be renewed for additional periods and thus become virtually a source of permanent working capital.

Bank loans may be either secured or unsecured. The unsecured note of a seller, provided he has a reputation for character and ability and provided his business is in a satisfactory state, is commonly considered sufficient. This is particularly true insofar as the loan is made to cover current sales. Such loans are self-liquidating. That is, an actual sale of goods has been made, and the normal expectation is that payment will be received. If the borrower himself has a good credit standing, collateral is unnecessary. The loan is made primarily because of the bank's belief that it can collect from the seller. It is his credit which is primarily considered.

On the other side of the transaction there is the buyer who may also borrow to make payment to sellers. In some cases, sellers do not extend credit to buyers and immediate payment must be made. In other instances, buyers may desire to make immediate payment in order to take advantage of the cash discount. If funds are not otherwise available to the buyer, a bank loan may be necessary. Such loans can usually be obtained on an unsecured note. But larger advances and a lower rate of interest may be offered if some form of collateral security is used, such as warehouse receipts or bills of lading. Since the goods are in the hands of the buyer and since he holds title to them, there is little reason for not using them as collateral.

In the marketing of raw materials, in particular, this type of secured loan is important. From the time when grain or cotton, for example, is sold at the farm, the products are commonly used as the basis for the loans needed to finance the purchases. Warehouse receipts are used to secure the loans which are liquidated when the product is sold.[2] Automobiles and other manu-

[2] See Chap. 21 for a discussion of the use of warehouse receipts in financing.

factured products are similarly used as collateral for loans as they are sold by manufacturers and purchased by distributors and retail dealers.

Accounts Receivable Financing. During the period since World War II, nonbank corporate financing has grown very rapidly. The growth of the economy during this time has resulted in substantial demands for additional working capital on the part of business enterprise, demands which could not be fulfilled by the banks either because of a shortage of loanable funds or because of the type of risk involved. Accordingly, many business enterprises have turned to factors and commercial finance companies for loans, using their accounts receivable for security. It is estimated that factoring and nonnotification loans against receivables amounted to some $11 billion in 1957 compared with about $4 billion in 1946.[3]

Factoring. Factoring involves a continuing agreement between the financial institution, or factor, and the client by which the former purchases the accounts receivable of the latter without recourse for credit losses and, when desired by the client, advances cash against these receivables.[4] Thus there are really two principal aspects of factoring. The first is that the factor assumes the credit and collection function for the client and all risk of nonpayment. In practice, the factor approves the extension of credit at the time of the sale, and the buyer of the merchandise is instructed by the seller to pay the invoice directly to the factor. The factor collects the account and remits the amount to the seller less the commission or fee which is charged for the service, usually from 1 to 2 per cent of the amount of the invoice after discounts. The commission is actually a service charge for the work and expense of assuming the credit and collection functions, the exact amount involved being subject to negotiation and depending upon a number of considerations such as the type of industry, the size of the client, and the number and average amounts of the invoices.

The second aspect of factoring is the advance of cash against the outstanding receivables, i.e., the lending of money. If the seller, or client, desires cash immediately, that is, before the average due date of the receivables, the

[3] In 1957 factoring constituted about 40 per cent of the total and nonnotification pledging of accounts receivable 60 per cent. The 1946 ratios were more nearly the reverse. See "The Postwar Surge in Factoring," *Business Week*, January 11, 1958, p. 84. Data on the amount of accounts receivable financing for earlier years are also given in Herbert R. Silverman, "Factoring as a Financing Device," *Harvard Business Review*, September 1949, p. 594; and in Raymond J. Saulnier and Neil H. Jacoby, *Accounts Receivable Financing* (New York: National Bureau of Economic Research, 1943).

[4] For more complete discussions of factoring, see Clyde William Phelps, *The Role of Factoring in Modern Business Finance* (Baltimore: Commercial Credit Company, 1956); and Theodore H. Silbert, "Financing and Factoring Accounts Receivable," *Harvard Business Review*, January–February 1952, pp. 39–54; as well as the references cited in the previous note.

factor will advance the cash and charge the client a rate of interest, historically and customarily 6 per cent per annum.[5] Although business firms that deal with factors no doubt do so in most cases in order to obtain financing when needed, it should be understood that the advance of cash against receivables is essentially a separate transaction which is not necessarily directly related to the assumption of the credit and collection function by the factor.

Prior to World War II, factoring was found principally in the textile industry where it has been the principal method of financing since the early 1800s. Because of its highly seasonal operations and many small manufacturers, this industry is considered to be especially adapted to factoring, and most of the so-called "old-line" factors have concentrated their efforts in textiles. At present, however, factoring is being used in many other lines: furniture, shoes, machinery, hardware, paper, chemicals, and the like. Some firms, however, are reluctant to deal with factors because of the notification feature. They fear that buyers, upon receiving notice to make payment to the factor, will interpret this as a sign of undue financial weakness. Therefore, many sellers outside the textile industry prefer the simple pledging of accounts receivable as security for loans, an act which does not require notification to the buyers.

Ordinary Accounts Receivable Financing. Ordinary or nonnotification accounts receivable financing involves an agreement whereby the financing institution purchases open accounts receivable as they arise, or advances funds secured by the pledge of such receivables, with recourse on the client for bad debt losses and without notice to the debtors.[6] As sales are made, the seller forwards account statements to the finance company which advances immediately from 70 to 95 per cent of the gross value of the accounts. Collections continue to be made by the seller who also forwards all payments on account to the finance company. Thus the amounts actually borrowed from the finance company may vary greatly day by day as receivables are pledged and collections made. The finance company makes an interest charge on the average face value of accounts pledged which may vary from 1/30 to 1/52 of 1 per cent per day, depending upon the percentage of the advance to receivables[7] and the current level of interest rates.

[5] When there is a shortage of credit and high rates of interest generally, a higher rate will be charged. For example, in late 1959 the going rate for loans by factors was 7.8 per cent, which is said to have been a record high as of that time. See *Business Week*, October 3, 1959, p. 27.

[6] Clyde William Phelps, *Accounts Receivable Financing as a Method of Business Finance* (Baltimore: Commercial Credit Company, 1957), p. 15.

[7] If the advance regularly amounts to 70 per cent of the receivables, the interest rate is lower than if the percentage advanced is, say, 90. Note that the interest charge is on the face value of accounts pledged not on the amount of the loan. A rate of 1/40 of 1 per

Nonnotification accounts receivable financing is a more recent development than factoring, the first such commercial finance company being organized in 1905. A number of additional companies began business between 1910 and 1920, but the volume of business in 1941 amounted only to $536 million. As indicated previously, a very substantial growth has taken place since World War II. Although the interest rates charged by commercial finance companies may appear to be rather high, it should be held in mind that other services, such as management advice, are often rendered and that the borrowers are usually firms which cannot qualify for the lowest bank rate in any event. Thus commercial finance companies are playing an increasingly important role in providing current funds to business enterprise.[8]

Open Account Credit. All the methods of short-term financing involve the use of credit. Whether funds are borrowed to pay cash at the time of purchase or soon thereafter, or whether the payment of cash is postponed by the buyer, the basis of the transaction is credit. Someone must have funds tied up in the goods which are being "carried." One of the main sources of credit from the buyer's point of view is in mercantile or trade credit, the sale of goods on credit by one business house to another. Between 80 and 90 per cent of such business transactions in the domestic market are made on credit. Although written credit instruments such as promissory notes and drafts are occasionally used, by far the most common form of mercantile credit is the sale of goods on open account.

Broadly, open account credit aids the flow of goods through the channels of distribution by enabling buyers to obtain goods while paying for them at another and later date. Specific businessmen, however, look on open account credit in different ways. To the seller it is a means of maintaining and expanding his sales volume. If he is unwilling to grant customers credit, he may find them taking their business to other sellers who are not so stringent in their credit requirements. Conversely, if the seller is willing to grant credit to buyers who cannot secure credit elsewhere, he will be able to expand his sales volume. He cannot grant credit to all potential buyers indiscriminately or he will find his credit losses too large, but it may be profitable to accept a certain number of credit losses if sales are expanded sufficiently in the process.

Buyers look on open account credit as a means by which they can secure

cent with a loan of 90 per cent of face value is the equivalent of an interest rate of 10.14 per cent per year, whereas an interest rate of 1/40 of 1 per cent on a loan rate of 75 per cent constitutes an effective interest rate of 9.92 per cent. See Phelps, *op.cit.*, pp. 38–9.

[8] Regular commercial banks may engage in accounts receivable financing, but the bulk of the volume is handled by commercial finance companies. Some of the latter also engage in factoring.

resources not otherwise available, and in the use of those resources they hope to earn a profit. In most cases the buyer will need to invest some money of his own in his business before he will be able to obtain credit of any type. A merchant who buys on credit and sells for cash, however, may be able to carry on his business with very little investment of his own. It is reported that the original Big Bear supermarket was started with an investment of only $1,000 on the part of the promoters; yet sales in the first year reached almost $4 million and profits totaled $166,507.[9]

The credit period involved in open account credit tends to conform to the time in which the purchaser expects to receive the funds with which to pay. Thus in groceries and foods, where the rate of stock turnover is high, the extension of credit by wholesalers to retailers is likely to be limited to seven days, a period during which it is expected that the goods will be sold by retailers to final consumers. As previously noted, in dry goods and ready-to-wear, extra datings are used and terms of 60 to 90 days are common. Actually the relationship between credit terms and rates of stock turnover is likely to be a very rough one and rather inexact. Most credit terms have their origin in historical considerations and industry customs which are not necessarily appropriate to modern business. A good example is the 2 per cent cash discount which was probably justified in an era when capital was scarce and the value of currency unstable. At present, however, it represents a very high premium for prompt payment and one which has little economic justification. For the same reasons, the length of the credit period is not always closely related to the needs of modern business, but customs are often difficult to change and existing practices tend to be continued.

FINANCING CONSUMERS

Consumer credit, as distinguished from mercantile credit, is credit granted to individuals for consumption purposes. It consists of two general types: (1) credit granted by retail firms and service establishments, or their financial agencies, for the purchase of goods and services, and (2) personal loans obtained by individuals from banks and other financial institutions. The marketing student is primarily interested in the first type since it involves the direct extension of credit in conjunction with the sale of merchandise. The net effect of both types is likely to be similar, however, since personal loans are obtained essentially in order to pay for goods and services that are being purchased or have already been purchased.

[9] M. M. Zimmerman, *Super Market—Spectacular Exponent of Mass Distribution* (New York: Super Market Publishing Company, 1937), p. 12.

Importance of Consumer Credit

The amount of consumer credit outstanding increased from $6,444 million at the end of 1929 to $52,046 million at the end of 1959, or from 7.8 per cent of total disposable personal income in the former year to 15.4 per cent in the latter. The data in Table 22-1 give a breakdown of outstanding consumer

TABLE 22-1
Consumer Credit Outstanding in the United States, by Types, at End of Year 1959

Type of Credit	*Amount (in millions of dollars)*	*Per Cent of Total*
Total	**52,046**	**100**
Instalment Credit	39,482	76
Automobile Paper	16,590	32
Other Consumer Goods Paper	10,243	20
Repair and Modernization Loans	2,704	5
Personal Loans	9,945	19
Noninstalment Credit	12,564	24
Charge Accounts	5,351	10
Single-Payment Loans	4,176	8
Service Credit	3,037	6

Source: Survey of Current Business, June 1960, p. 517; percentages computed by the writers.

credit at the end of 1959. Instalment credit amounted to 76 per cent of the total, the largest portion of which—some 52 per cent—consisted of the financing of the purchase of automobiles and other consumer durable goods. Regular merchandise charge accounts amounted to 10 per cent of the total credit outstanding, and service credit, which is also open account credit, constituted 6 per cent. Thus more than two thirds of all outstanding credit was directly connected with the purchase of consumer goods and services.

It is evident that consumer credit is a very important factor in the economy of the United States. Moreover, it seems to increase in importance each year. The extent to which retail sales are actually made on credit is not revealed, however, by the above data, and no exact information is available. Some retailers, such as supermarkets, do not grant credit at all. In most merchandise lines, however, credit is readily granted by retailers, and credit sales in some types of retail institutions, such as service department stores, amount to 60 or 70 per cent of total volume. General merchandise retailers, even those

which traditionally have emphasized cash sales, are more and more turning to the use of credit. For example, the J. J. Newberry Company in 1955 installed full credit facilities in each of its retail outlets, and in 1959 Sears, Roebuck and Company and Montgomery Ward and Company both inaugurated 30-day charge account service to supplement their instalment credit plans.[10]

Credit is extended, of course, as a convenience to the consumer. But the philosophy of credit extension is much more involved than this for the modern general merchandise retailer. Credit is actually a selling device, a method of sales promotion. The availability of credit is advertised and promoted by the retailer in the same way and for the same reason that he promotes his selection of merchandise or his price lines or his convenient location. Charge accounts are actively solicited rather than being merely available—*because the charge customer buys more merchandise more often than does the cash customer.*

For this reason, there has been since World War II a great liberalization of credit terms and a concentrated effort on the part of many agencies to provide a credit card for every occasion and a credit plan for every purse. Airline tickets and trips to Europe can be charged and paid for on the instalment plan The holder of a Diners' Club or American Express Company credit card can purchase a wide variety of goods and services from various establishments, not only throughout the United States but in many other countries as well. And banks have also entered the credit card field, permitting the holder to charge at any local affiliated store and pay the bank rather than the store. These and other developments will be discussed in the following sections.

Types of Consumer Credit

Credit involving the purchase and sale of goods and services can be classified into two general types: open account credit and instalment credit. The distinctions between the extremes of these two types is very clear. The regular charge account is the principal manifestation of open account credit, whereas a clear example of instalment credit is the making of a down payment on a purchase followed by a series of monthly payments with interest being charged and the entire transaction secured by a chattel mortgage or conditional sale agreement. In practice, however, distinctions are sometimes diffi-

[10] Sears, Roebuck and Montgomery Ward first offered instalment credit during the thirties and permitted any purchases totaling $10 or more to be paid for in instalments. As of 1958, Sears' credit sales amounted to 47 per cent of total volume. See *Business Week*, August 9, 1958, p. 38. For an account of the Newberry experience, see Walter C. Straus, "Newberry's Goes After Charge Business—and Finds It Good," *Credit Management Year Book, 1958–1959* (New York: National Retail Merchants Association, 1958), pp. 18–22.

cult to make because of the tendency of retailers to establish a variety of credit plans to fit the various needs of consumers.

Open Account Credit. The regular so-called "30-day" charge account is the typical form of open credit. A statement or bill is sent by the retailer or service establishment at the end of the month for all purchases made during the month, and payment is supposed to be made by a stipulated date of the following month, usually the tenth or fifteenth. This routine is frequently disrupted, however, by the use of "cycle billing" by retail stores and service establishments. In order to even out the work of the billing department, many retailers and service businesses, especially the large ones which have a multitude of accounts, close accounts and send out statements each day throughout the month for a certain group of customers. Bills are then due 10 to 15 days after the receipt of the statement, or at some other stipulated date.

Open account credit may also be extended for periods longer than "30 days." Where this is a feature of a regular credit plan, it may be difficult to distinguish from instalment selling. Many retailers advertise terms of one third in 30 days, one third in 60 days, and one third in 90 days with no interest charge. Where there is no chattel mortgage or conditional sale agreement permitting repossession of the merchandise, and no interest or service charge or offsetting discount for cash, such a transaction appears to involve essentially open account credit even though payments are made in instalments.

Many retailers, especially department stores, give even longer terms. Not uncommon is the revolving credit plan. There are numerous modifications, but the general arrangement is to establish a line of credit, say $300, purchases being permitted up to this amount. One sixth or one tenth of the outstanding balance is then paid each month. Thus in the six months plan, if the full $300 of merchandise is purchased immediately, $50 is paid at the end of the first month, and an additional $50 of merchandise can then be charged to the account. Regardless of the amount of the purchases actually made, one sixth of the amount is paid each month. An interest or service charge is normally made on the unpaid monthly balance in this type of credit, usually 1.5 per cent, and contracts are sometimes signed whereby the customer agrees to make the monthly payment. In such cases, the transaction probably should be regarded as instalment credit rather than open account credit although there is no repossession agreement involved.[11]

As noted previously, open account credit is granted to the consumer

[11] Some banks have also entered the revolving credit field through the use of "revolving check credit." A line of credit is established with the bank and the individual writes checks against it. Repayment terms and interest charges are similar to those already described, except that twelve month plans with an interest charge of 1 per cent per month are probably more typical of bank plans.

primarily as a convenience and to make it easy for him to buy. The credit customer has closer ties to a particular store and tends to buy more merchandise there than is the case with the cash customer. He also tends to buy more merchandise in total. Accordingly, among certain types of retailers, there is substantial competition for credit accounts and a continual tendency to liberalize payment terms in an effort to attract more credit business. The result is an increase in the cost of credit extension to the retailer for which he may or may not be directly compensated by the consumer.

The cost to the retailer of extending open account credit is typically assumed to be about 5 per cent of sales, although costs are likely to vary considerably depending upon the credit policies of the firm. These costs are incurred primarily in the recording of the transactions, in billing and receiving payment and other office routines, and in providing current funds for operations while waiting for payment. Bad debt losses are not a substantial cost factor for most firms, amounting on the average to less than 0.5 per cent of sales. Most consumers do pay their bills although many of them do not necessarily pay promptly. When this is the case, obviously the costs of credit extension increase. In any event, the 5 per cent figure is probably a conservative estimate of cost for many stores, since it is difficult to isolate and compute all of the costs involved in credit extension.

Since 1950 there has been a tendency for banks to enter the retail credit field by providing a service which is usually designated as "charge account banking." Consumers make their credit arrangements with the bank which issues a credit card to each person approved. This card permits the holder to charge purchases at the designated stores which have joined the plan. When a credit purchase is made, the retailer sends the sales slip to the bank which credits the retailer's account immediately with the amount of the sale less a service charge of 5 or 6 per cent. At the end of the month, the bank bills the customer in one statement for all charge purchases at those stores which belong to the plan. If the customer pays promptly there is no financing charge, but if payment is delayed or made in instalments an interest charge is added.[12]

There are obvious advantages to charge account banking. There is added consumer convenience, provided most retailers join the plan, since only one credit card need be carried and one payment made at the end of the credit

[12] For an account of one of the early charge account banking plans, see Joseph M. Russakoff, "Retailers Get Rid of Banking," *Journal of Retailing*, Fall 1952, pp. 107–10 and 139. As of 1958, it was estimated that some 60 banks, generally those in small communities, were offering this service. In October 1958, the Chase Manhattan Bank in New York announced adoption of charge account banking, and since that time many additional banks have entered the field. See *Business Week*, October 25, 1958, p. 96.

period. The retailer himself is relieved of the burden of credit management, although not the cost. All risk of nonpayment is shifted to the bank, as well as any possible customer ill will that may result from unusual but necessary collection efforts. Charge account banking is likely to be particularly appealing to the small retailer who does not have either the management or financial resources to compete on equal terms with large retailers in credit extension. With the bank underwriting and administering the entire program, he is in a position to offer a more complete service than would otherwise be possible without undue diversion of management effort to the credit function.

On the other hand, charge account banking deprives the retailer of one of the main advantages of open account credit. The customer now in effect has an automatic charge account at every member store and is no longer tied to any one retailer by virtue of the credit being extended by that retailer. For this reason, few large retailers have been interested in joining charge account banking systems. For such firms in particular, credit is a promotional device the value of which is greatly reduced by joining any group plan.

Instalment Credit. Although more merchandise is actually sold on open account than on the instalment plan, the effect of instalment credit upon the economy is greater than is the effect of open account credit. The reason for this is that instalment credit requires a much longer period of time to repay and thus affects the consumer's ability to make new commitments for that period of time. As previously noted in Table 22-1, the amount of consumer credit outstanding at a given time is heavily weighted with instalment credit and especially with instalment sales credit.

According to the traditional view, instalment credit is designed for use in the sale of durable goods of relatively high unit cost which have a repossession value: automobiles, major household equipment items, furniture, and similar goods. A significant down payment is required together with additional monthly payments which are limited in number. A chattel mortgage or conditional sale contract is used, permitting repossession at any time that payments are in default. The repossession value of the good at any given time is in excess of the unpaid balance. Thus the seller or his financing agent can hardly lose on the transaction, and the consumer can enjoy the use of the good while he is paying for it.

Modern-day instalment selling, however, has departed from these principles in many ways. Down payments and monthly payments have become smaller and smaller, thus increasing the length of time for which credit is extended. The buyer's equity in the good is thus likely to be so small at any given time that the repossession value of the item is less than the outstanding balance owed. Of even greater significance, instalment credit is now extended

to merchandise which has no second-hand or repossession value at all. In fact, many retailers permit any purchase or combination of purchases of a certain minimum amount, such as $20, to be paid for on an instalment basis. Thus instalment credit is often granted on the same basis as open account credit rather than on the security or repossession value of the item purchased. Experience seems to indicate that most regularly employed consumers are good credit risks.

Advantages and Disadvantages of Instalment Credit. Many arguments are made both for and against this method of financing consumer purchases. The major arguments against instalment sales are not based on the resultant credit losses. In some lines they are no greater than the losses on open account credit, and in any event they are not of great significance and can easily be provided for in the price of the goods or in the instalment charges. But there are abuses in instalment credit and it is very easy for the modern consumer to become overextended and assume too heavy a burden of debt for his own welfare. Moreover, consumers often pay too little attention to the cost of instalment credit.[13] If the monthly payment seems reasonable, no effort may be made to ascertain carrying charges and interest rates. And very little consideration appears to be given to the alternative of postponing consumption until cash can be paid and using the savings in interest to buy additional merchandise. Interest rates on instalment credit commonly amount to 11 to 12 per cent of the average unpaid balance, and frequently there are service charges in addition. Payment of these costs necessarily curtails the amount that consumers can spend for additional goods.

Another major criticism is that economic fluctuations are accentuated. The chief products bought on an instalment basis are durable items which are purchased in large volume when business conditions are good. But during periods of recession or depression, purchases decline as existing products are made to serve for a longer time. Instalment selling encourages purchases of such goods in periods of prosperity, but when business conditions are bad the normal decline in sales is accentuated by the need to continue payments on old instalment contracts. Moreover, some people find it impossible to maintain instalment payments, repossessions take place, and the repossessed items add to the surplus of products available in the market. Against this argument it is pointed out that the well-managed companies that finance this business have shown their soundness in periods of depression, and that

[13] According to one study, two thirds of the users of instalment credit did not know the amount of the carrying charge or interest rate on their most recent instalment purchase. Moreover, the larger the amount of credit involved the less was the knowledge of the carrying charges. See Jean M. Due, "Consumer Knowledge of Installment Credit Charges," *Journal of Marketing*, October 1955, pp. 162–6.

expansion and restriction of credit in times of prosperity and depression are much greater in other types of credit.

The advantages of instalment credit arise from the fact that many people will not save in order to buy expensive items, but they will pay for them if they can buy first. Obviously, instalment credit is almost a necessity in the purchase of some products, and its availability has greatly increased the sale of such items. This has made it possible to expand the use of mass methods of production, thus reducing costs and leading to still further expansion of markets. In fact, it is sometimes argued that the resulting expansion of markets for some durable goods—automobiles, for example—has made possible reductions in manufacturing costs and improvements in the product which more than offset the consumer's cost of buying on the instalment plan. Furthermore, the development of finance companies has reduced the amount of capital tied up in credit extensions on the part of manufacturer, wholesaler, and retailer and so has conserved their working capital. It is also argued that in no other way could many persons ever own these expensive products, and that many others enjoy them much sooner than would otherwise be possible. Finally, it is pointed out that the carrying charges on instalment selling are lower than those charged by personal loan companies to which more persons would resort if they could not buy on instalments; and that, because instalment credit is largely administered by well-managed finance companies, it is on a more sound basis than the retail charge account as usually administered.

Regulation of Instalment Credit. Because of certain abuses in the use of instalment credit and because of the effect of instalment sales upon the economy, there has been a certain amount of regulation of instalment transactions. Most of this regulation has been at the state level where the primary interest is in consumer protection. The first such law was passed in Indiana in 1935, and by 1950 there were twelve states with legislation of this type.[14] During the latter half of the fifties, as reports of exorbitant charges and other abuses became widespread, a number of additional states entered this legislative field, and many existing statutes were amended to provide for better control.

State laws regulating instalment sales credit generally require that all charges be disclosed and clearly stated. Some laws regulate the amount of the carrying charges or "pack" that can be imposed, and some regulate the amount of the commission or "kickback" that the finance company pays the dealer for the contract. Regulations are also usually established with respect

[14] See Wallace P. Mors, "State Regulation of Retail Instalment Financing—Progress and Problems," *Journal of Business*, October 1950, pp. 199–218, and January 1951, pp. 43–71.

to refinancing and repossession. In some cases there is outright regulation of the rate of interest that may be charged by the financing agency.[15]

The interest of the federal government in the regulation of instalment sales has been primarily from the point of view of the effect upon the economy rather than the effect upon immediate consumer welfare. Thus during World War II, when it was desirable to discourage consumer spending in order to limit the amount of inflation, instalment selling was regulated by the federal government. Minimum down payments were specified for various types of merchandise, and the total length of time for which credit could be extended was also regulated.

In 1956 the Board of Governors of the Federal Reserve System undertook a study of consumer instalment credit to determine whether permanent regulation was necessary, in view of the constant increase in the amount of such credit being extended and its potential effect upon the economy. A great deal of information was collected in connection with this study,[16] but it was not considered necessary at that time to recommend permanent regulation. No doubt the future growth and impact of instalment credit will be carefully watched

There appears to be little doubt that the use of instalment credit has contributed significantly to the development of the economy and in most cases to consumer welfare. There can also be little doubt that abuses exist and that the consumer does not always make wise decisions with respect to the utilization of such credit. Nevertheless, the sale of goods on the instalment plan will continue, and every possible effort should be made to remove the abuses and evils that exist. Governmental regulation very likely will constitute an increasingly important phase of this effort.

QUESTIONS FOR DISCUSSION

Consider the general problem of governmental regulation of consumer credit, especially instalment sales credit. Should there be widespread regulation of this field, and, if so, what type of regulation? There are really two aspects to this problem. The first is that of consumer protection, which is exemplified by the state laws mentioned in the text. A proposed federal law of this type has been introduced in Congress, however. Should this bill be passed or should the consumer protection aspect be left to the states? Why or why not?

[15] For example, the California law passed in 1959—which applies to all instalment sales of goods and services—limits credit charges to 10 per cent of the first $1,000 of a contract and 8 per cent of all amounts in excess of $1,000. These are nominal rates, and the actual interest rate per annum will depend upon the length of the payment period. See *Business Week*, May 16, 1959, p. 128.

[16] See *Consumer Instalment Credit*, 6 vols. (Washington, D.C.: Board of Governors of the Federal Reserve System, 1957).

The second aspect is the effect upon the economy. During World War II the federal government, through the Board of Governors of the Federal Reserve System, established certain requirements as to the amount of down payments and the number of months over which payments were permitted. Should this type of regulation be made permanent, with credit terms being tightened or made more lenient according to the state of the economy?

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23. MARKETING RISK

During the entire marketing process there is danger of loss from unforeseen circumstances. This uncertainty, or risk, is assumed by those who take part in marketing and particularly by those who take title to goods. There is risk of loss from fire, flood, storm, theft, deterioration, and from bad debts or general financial difficulties outside the control of the individual. Fashions may change or the market may be misjudged, leaving unusable products in the hands of those who have produced them or purchased them for resale. Increased supplies, reduced demand, or changes in the value of money may change the prices of commodities. Some of these risks can be wholly or partly insured against, or the burden can be shifted to the shoulders of those who specialize in bearing them. With many others, however, the businessman as producer or middleman must himself contend. In this chapter attention will be given to the nature of marketing risks and to methods of minimizing risks. Protection against risk of price change by means of futures trading on organized commodity exchanges will be discussed in some detail.

CAUSES OF MARKETING RISK

The risks involved in the marketing of goods vary greatly both in origin and in effect. For purposes of the discussion here, they will be classified into three groups on the basis of cause: (1) those risks resulting from changes in market conditions, (2) those resulting entirely or largely from natural causes, and (3) those arising partially or wholly out of the human element.[1] The first of these three is the most significant.

Risks Arising from Changing Market Conditions

The greatest risk in marketing results from price fluctuations caused by changing market conditions. Price changes cause actual loss, or the loss of

[1] It is clear, of course, that these groups are not mutually exclusive.

potential profit, to those who own goods and to those who must purchase them. If, for example, the price at which a farmer sells his grain is higher than the cost of producing it, the farmer operates at a profit. If the grain sells for less than the cost of producing it, he suffers a loss. If the price at which it sells is higher than prospective purchasers had anticipated, their potential profits decline, or actual loss may result to some or all of them. But when the price is lower than they had anticipated the gain is theirs, and a loss may be sustained by the farmer. All producers bear risks of this kind. And all middlemen, particularly merchants, are confronted by them. Anything, then, which affects the demand for or supply of a product, or which brings about a maladjustment of demand and supply—such as poor crops, deterioration of goods in storage, fashion changes, new and competing products—influences its market price, and may thereby cause loss to some and gain to others.

Time Risks. Most of the risk arising from market conditions is due to the passage of time. Goods are bought with the hope or expectation that they can be sold later at a price that will net a profit, but anticipated prices are not always realized. The wholesaler incurs this type of risk when he buys a product for later sale to retailers. The retailer runs a similar risk in buying from the wholesaler or manufacturer, expecting to sell at a profit to the consumer. But consumers may not buy at a price that is profitable to the retailer. He is unwilling then to restock at the old price, or perhaps in the former volume. The wholesaler, nevertheless, may have already bought from the producer, and so he in turn suffers loss. The producer incurs a like risk, for he must use capital, labor, and raw materials in producing his product, although by the time it is ready for market there may be no demand, or such demand as exists may be at a price so low that loss will ensue.

Modern methods of production make the time element particularly important, and thus influence market risks. Production commonly involves fixed investments and heavy expenditures which may have to be made years before the product is ready for the market and the proceeds of its sale can be expected to return profits or to safeguard the principal. A steel manufacturer, for example, buys land, constructs a plant, procures materials, and employs labor with which to make steel to sell to a manufacturer of electrical supplies. The latter in turn has invested with the expectation of selling some of his output to a manufacturer of electric fans, and the fan manufacturer proposes to sell his product to the public. But in the meantime room air-conditioner units are put on the market at prices which curtail the profitable demand for electric fans. This necessitates a readjustment all along the line.

Of course, it is true that the plant of each manufacturer can be adjusted

to the new needs of the market. But this may involve expenses which were not anticipated and which some of the manufacturers may be unable to meet. Other manufacturers, furthermore, having foreseen the change that was to take place, are by now well entrenched. If those who were less successful in their forecast of the market succeed in securing an adequate volume of sales, it may be only at an excessive selling cost.

There are many other unforeseen circumstances that affect marketing risk. For example, the manufacturer of room air-conditioners may estimate that he can sell a certain number of units during the forthcoming summer season, and he establishes production schedules accordingly. But when the season opens, although he has a large stock ready to ship, and materials and equipment and labor for making more, the air-conditioners do not sell as rapidly as anticipated due to an unusually cool summer. Or perhaps, after a good start, demand falls off as a result of improved models being offered by competitors. Again, a reduction in business activity and employment may depress the market, or a strike in the steel industry may result in a lack of steel for the manufacture of the product.

A large part of the investment in modern industry is relatively permanent, and often cannot be salvaged after adverse market changes except by changing the equipment and the product manufactured. This may involve great expense, and even then the market may not be large enough to take the new output at a price that will net a profit. If the new product does not appeal to the public, or if the plant cannot be readily transformed, it may even be necessary to dispose of the plant at a considerable loss. Surplus stocks of goods containing the results of large investments in labor, materials, and capital may lie in the warehouse unsold, or they may have to be sold at less than cost. It is evident that, since the investment and expenses of many producers anticipate the market for years ahead, an error in judgment or a change in conditions may result in large losses.

Place Risks. Place risks arise from the fact that prices for the same commodity are not in line at different points of sale. That is, different price levels prevail because the commodities are in different places, rather than because a period of time has elapsed during which prices for the commodity have changed in all markets. Such risks are now minimized. Market news spreads so rapidly that in well-organized markets it is seldom possible to buy goods in a market where prices are low, transport them to a market in which prices are higher, and then sell at an extraordinary profit. Neither is it likely that goods purchased in one market will have to be sold at a heavy loss in another market, simply because prices are lower there than in the first. This is true because such gains or losses as these can arise only out of the lack of knowledge

of conditions in one market by those who are in another. But in markets which are not highly organized, in buying and selling perishable commodities, or in dealing with uninformed buyers or sellers, profits may be taken and losses occur because prices in different markets are out of line.

Risks of Competition. A general change in demand is not the only market risk that the producer must face. A competitor may revise his method of manufacturing so as to improve the quality or lower the costs of his merchandise, or he may improve his methods of selling. In consequence, prices may be reduced and demand diverted by competitors until a particular producer, if he cannot utilize the same or equally successful methods, is forced to sell at a loss or even to go out of business. Middlemen likewise must contend with competition. The independent retailer finds that he is losing business to a contract chain operator around the corner, or to a new shopping center that has been recently established. Modern-day competition in marketing is so dynamic that every businessman must be constantly alert to the actions of his competitors and their effect upon his operation.

Other Causes of Risk

Enough has been said to show that business is an undertaking involving great risk, most of which arises out of market conditions. But there are two other familiar classes of risk to which the businessman is subject, and which may have a very direct effect on his marketing activities and their financial results.

Natural Risks. Natural risks include the possibility of loss from causes beyond the control of man. Such causes include rain, wind, lightning, hail, earthquakes, disease, vermin, heat, and cold. For example, in the marketing of livestock, although all normal precautions are taken to prevent loss from overheating during extremely hot weather, some animals may die en route to market. Or a windstorm may cause loss of material or added costs of handling in a lumber yard.

Risks Resulting from the Human Element. Some uncertainties or risks arise partially or wholly out of the human element. Examples are the possibility of loss through dishonesty, such as embezzlement by employees and pilferage by employees or outsiders; bad debts due to insolvency (or dishonesty) of debtor-customers; spoilage, breakage, or other losses due to carelessness or incompetency on the part of employees; premature death or serious illness of executives whose knowledge and personality may be important factors in the success of the business; legal liability for injury to employees or customers; and outside risks such as strikes, industrial depression,

and war. A type of risk which has become of increased importance is that of governmental activity resulting in new forms of taxes or in legislation and regulations which may require extensive record keeping and costly modifications of established marketing practices.

METHODS OF MINIMIZING RISK

Effort is constantly made to eliminate risk, or at least to minimize its effects. There are two general approaches to minimizing risks: (1) efforts to prevent the occurrence of a loss by eliminating its causes, such as special fire prevention measures, and (2) the shifting of risks that cannot be eliminated to persons or agencies that are more willing or better qualified to bear them. Insurance and contracts of purchase and sale are examples of shifting or dividing risks.

Preventive Efforts

Preventive measures designed to eliminate the cause of a risk or to reduce the chance of occurrence are generally the responsibility of individual businessmen, and the success of a particular firm in minimizing its risks is likely to depend in a large part upon the quality of the management of the firm. It is obvious, however, that most risks cannot be completely eliminated regardless of the extent of the individual management efforts. When this is the case, and particularly when the risk arises out of competitive conditions, it is not unusual for a group or association of competitors to take collective action in an attempt to reduce the incidence of the risk. Finally, there are certain types of marketing risks of sufficient importance presumably to the general welfare to require governmental regulation of, and assistance to, those who must bear them.

Individual Management Efforts to Reduce Risk. There are many measures which alert managements can take to minimize risk. The construction of fireproof buildings and the adoption of various fire prevention measures decrease the fire hazard. The careful granting of credit and improved methods of collecting accounts reduce bad debt losses. The use of safety vaults, night watchmen, burglar alarms, and the inculcation of ideals of honesty minimize losses from burglary and theft. These and many other measures can be taken to reduce the risk of loss from natural causes and from the human element, provided the cost of the preventive measures appears to be warranted by the importance of the risk.

The more important marketing risks, however, are due primarily to price

fluctuations, particularly those resulting from unexpected changes in the demand for and supply of commodities. These risks, as previously mentioned, are of great significance to modern specialized producers and merchant middlemen, in view of the fact that production must take place and purchases must be made in advance of the final demand for the products. The methods used to combat this type of risk lie primarily in individual management efforts to sell effectively and to obtain as much knowledge as possible about the market.

Effective Sales Efforts. For both producers and middlemen, effective sales efforts are a major way of avoiding or minimizing the risk of reduced demand. Goods may be advertised and promoted with a view to increasing or maintaining demand and avoiding the risk of substitution. As buyers become familiar with certain trade-marks and brands, there is less danger that the manufacturer will lose a sale through the substitution by the retailer of another product. If, through effective sales efforts, a retailer builds a reputation in his community for giving outstanding merchandise values, he lessens the risk of loss of business to a new competitor. Even though a seller may not be able to convince the buyer that his product is the one most desired or that his firm is always the best one with which to deal, selling effort may, nevertheless, create a favorable attitude of mind which makes later sales efforts more effective. Through such means markets are maintained or improved, and the risk of loss from a declining demand is reduced.

Minimizing Risk Through Knowledge of the Market. Since market risks arise from changes in the conditions of demand and supply, an important means of reducing them is to obtain accurate information about the market. If a manufacturer believes there is to be a shortage of a raw material which is essential to his business, he is likely to go into the market early in order to buy it as cheaply as possible, or even to make sure that it can be procured at all. On the other hand, if he believes that the price of that raw material is likely to go down in the immediate future, he will wait until it is actually needed before ordering so that he can take advantage of the lower price. In the same way, the greater the knowledge the seller has of market conditions, the more his plans can be made to conform to the actual market situation as it unfolds. Market risk is thereby reduced.

With rapid perfection of the means of communication and the accompanying increase in the knowledge of market conditions, it would seem that market risk could be increasingly minimized. But industry and commerce, on the other hand, are constantly growing more complex and market conditions more difficult to predict. Thus, of the factors affecting demand, many cannot be predicted far enough in advance to remove risk from the producers

and merchants who undertake to supply our needs. Natural causes which affect the market, for example, are very important, but they are not predictable with any degree of certainty. A cold winter causes a fuel shortage because demand is great, and transportation may be tied up; a warm winter means a smaller demand. A cold spring reduces the demand for clothes and foods normally associated with that season. Again, the uncertainty of human desire makes a correct anticipation of the market difficult. This problem of predicting demand is particularly important in the sale of fashion goods. Fashions may be incorrectly forecast, or popular styles may decline in favor more rapidly than was anticipated. Finally, the particularly effective sales efforts of some competing firm may divert demand from other producers.

On the side of supply, important factors are commonly difficult to forecast. Two of these are the type and volume of goods which competing producers are going to have for sale. Manufacturers in many lines are constantly working on new products and on improvements or changes in old products. This is commonly done in secret, in the hope that the products may be ready for market and advantages may be derived from their sale before competitors can imitate them or bring out new products of their own. Volume is particularly difficult to forecast in a small-scale industry, such as agriculture. A large crop of potatoes, with resulting low prices, may lead to a general feeling that a smaller crop should be produced the following year, but no one can be certain until after planting and harvest that this has actually been accomplished. With respect to farm products particularly, the volume and quality of production are sometimes beyond human control.

Collective Action by Competitors. Agreements among competing firms are also used to reduce marketing risk. An understanding among competing manufacturers that they will allow but 30 days' credit reduces the credit risk and regulates competition in credit granting. An agreement among retailers to sell coal at prices established by a local board does away with competition which might be manifested in price cutting. An agreement to limit retail deliveries, or the establishment of a cooperative delivery service, lessens competition in delivery service, and thus narrows the field of competition. An agreement among manufacturers to allot territory among certain firms on a definite basis, or to limit production to a fixed maximum, likewise limits risks. An understanding among competing producers that they will follow the prices of a particular large operator stabilizes price competition.[2]

Again, when a manufacturer or dealer buys up or merges with strong competing manufacturers or dealers, he thereby removes competitors and so reduces the risk in his market. An important object of many mergers and

[2] Some of these activities are illegal in the United States. See Chap. 29.

consolidations has been to reduce or to remove entirely certain risks of the market, with a particular view toward eliminating the risks that arise from competition.

Governmental Regulation and Assistance. When the government places a tariff on imports of manufactured products and when it guarantees a minimum support price for wheat by making loans to farmers on stored grain which it does not expect to collect in full if prices fall below the amount loaned, the risk of loss from a lower price is reduced or removed from the manufacturer or farmer. The risk is thereby shifted to the government. If the resulting price causes overproduction or permits the continued existence of inefficient production facilities, a greater social loss may occur than would have taken place otherwise.

When a maximum price for the railroad rate between two points is definitely established, the risk to the manufacturer of paying a higher rate than had been contemplated when prices were quoted or when orders were taken is eliminated. When special price concessions are made illegal, and the law is enforced, small buyers are saved from the loss that may arise from a larger competitor's ability to undersell them because he is able to buy at lower prices. Many other similar examples could be cited whereby governmental intervention eliminates or reduces marketing risk.

Shifting and Dividing Risk

Individual and collective management efforts and government assistance are important means of lessening marketing risk. But they can seldom eliminate it. And risks that cannot be avoided must be borne by someone. They can sometimes be shifted or divided, so that the burden does not fall too heavily on any one businessman. This is accomplished to a large degree through the use of insurance and by means of contracts of purchase and sale including contracts for future delivery.

1 **Insurance.** Many of the natural risks and some of the risks arising from the human element, or from a combination of natural and human causes, can be avoided or minimized by the use of insurance. Insurance does not eliminate risk; rather it produces an averaging of risks. The one who suffers a loss does not bear it in its entirety, since a large number cooperate in carrying it. Each pays a proportionate share of the amount which will cover the losses likely to occur in the whole group. Only a few will lose, but they are protected against excessive loss. Since any one of the group may suffer loss, each is willing to pay into the common fund maintained by the insurance company in order to protect himself in case he should be one of those to lose.

The main effect of insurance then is to relieve those insured from a part of the risk they otherwise bear alone, a privilege for which they are willing to pay.

Insurance is very important to small producers whose activities are not broad enough or large enough to make their risks relatively constant. Thus a retail dealer or a small factory may lose everything through a fire or flood, whereas a very large firm with many buildings and plants in scattered parts of a country is not likely to suffer many such losses in any given time. Its danger of excessive loss is relatively small. Both individual and society would suffer if the small but efficient merchant or manufacturer were left destitute from an unforeseen catastrophe. But through insurance he is protected from such a possibility, and may return to his business. To large companies also, the advantages of insurance may be great, even though the relative importance of any individual loss may be small. Among the risks which may be insured against are the following: fire, tornado, hail, death, accident, disease, burglary, violation of trust, bad debts, and interruption of business due to fire or other causes.[3]

Insurance is of importance to all who are engaged in marketing. It is an important factor in eliminating uncertainty, and so in making the market machinery perform more smoothly and at a reduced cost. This is well illustrated in connection with financing. When a bank makes a loan on combustible merchandise in storage or in transit, it usually insists that the merchandise be insured against loss from fire. Otherwise the risk to the owner of the goods, and hence to the bank which has loaned him money, is too great to warrant a loan. When goods are shipped by water the dangers of loss at sea are provided for by means of marine insurance. By means of insurance, likewise, risk of loss from bad debts, theft, and defalcation may be guarded against. All of this tends to remove uncertainty and so to reduce the ultimate cost of marketing.

Contracts of Purchase and Sale. Contracts of purchase and sale permeate the entire business structure. An illustration of shifting risk by means of contracts can be taken from the construction industry. Assume an office building is to be constructed and that bids from general contractors are being obtained. The contractors make their estimates on the basis of the cost of materials,

[3] A merchant who suffers a loss due to fire may find that it takes considerable time to replace any merchandise damaged or destroyed and to render the premises fit for operation. In spite of interruption of business many expenses may continue, such as salaries, rent, taxes, and insurance permiums. In addition the merchant may suffer a loss of profit due to his inability to operate the business. Business interruption insurance (also called use and occupancy insurance) provides indemnity for such expenses and loss of earnings during suspension of operation occasioned by fire or other perils insured against. Such insurance, if properly written, will do just as much financially for the insured during the period of business interruption as the business would have done if there had been no interruption.

labor, and supervision and submit bids. When the contract is let, the successful contractor, probably on the basis of previous understandings on which he has based his original estimate, may proceed immediately to let subcontracts for materials and for the construction of certain parts of the building. He contracts to buy cement, sand, stone, and steel, with which to construct the reinforced concrete parts of the building; he contracts for the plumbing and the electrical work with other contractors, who in turn contract for the materials they will use. In this way the original contractor shifts much of the risk to suppliers and to other contractors.[4]

Risk is shifted in such instances; it is also minimized. Each one with whom contracts are made is presumably an expert in his special field. Expert knowledge of the market insures, consequently, that materials will be bought under the most favorable circumstances. This enables each specialist to offer a price lower than that on which the general contractor would have based his estimates had he himself been forced to take the entire risk. Total knowledge of the markets involved in the construction of the building is very much greater under these circumstances than it would be if the original contractor should forecast all the markets and bear all the risk. Consequently, the total risk is less. Furthermore, the averaging of risks by those who contract reduces the danger from a failure to anticipate future conditions accurately in a particular case. This is especially true of those who provide materials. They know that there will be losses on an order now and then but that profits on other orders will be greater than they had anticipated. In a competitive business, consequently, prices will be quoted that are lower than they could otherwise be.

Similar examples are found in other industries. The manufacturer who has sold his output for a year in advance has removed risk on the demand side of his market. If he contracts for raw materials he has removed risk on the side of supply.[5] The farmer who sells his crop before it is harvested, or even before it is planted, has removed risk on the demand side. Those who make such contracts may forego the chance of larger profits from a market offering higher prices at the time they are called on to deliver, but they also remove the risk of a falling market.

In normal business operations, risk is divided among various agencies in a channel of distribution. It has been shown in earlier chapters that middle-

[4] In times when deliveries are uncertain, and prices and wages are tending to increase rapidly, contractors are often unwilling to contract to deliver at a stipulated price. Under such circumstances they may shift the risk upon the party desiring the building by agreeing to construct it on a cost-plus basis.

[5] This is, of course, on the assumption that contracts will be fulfilled, and without recourse to the courts.

men perform an important service in bearing marketing risks. Raw materials wholesalers buy directly from producers, frequently before contracting for resale. Manufacturers and other merchants sometimes contract with these wholesalers for materials not yet in their possession, so that their risks arise from both the supply and demand sides of the market. Merchants who wholesale manufactured products commonly buy, or contract to buy, goods before they are sold to retailers, and in other cases contract to sell to retailers before they have purchased the goods. Finally, retailers contract for and stock goods which consumers have not ordered. The merchant middleman is thus important in making it possible for producer and consumer alike to shift risk. As a specialist in distribution, who frequently has an expert knowledge of his markets, he is peculiarly fitted to do this.

The marketing of agricultural products involves an unusual amount of risk of price change. Most such products are harvested in large quantities at certain seasons of the year but must be carried over so that they may be consumed uniformly throughout the year. The length of time involved in this process makes for substantial carrying charges and price risks. In order to facilitate the making of contracts for future delivery, organized commodity exchanges have been established for certain agricultural products, and for some natural raw materials as well. To the extent that speculators engage in trading on these exchanges, regular middlemen and manufacturers are able to shift some price risks to these speculators through hedging transactions. Because of the importance and complexity of futures trading and hedging on organized exchanges, a somewhat extended discussion is presented.

FUTURES TRADING AND HEDGING

Contracts calling for future delivery are common in many types of business. But the term "futures trading" is used here to apply to a special type of futures contract bought and sold under the rules of organized exchanges which facilitate and control the transactions.

Organized Commodity Exchanges

There are approximately 25 organized commodity exchanges in the United States which deal in futures contracts for some 30 or 40 commodities. Sixteen of these exchanges are licensed by the Commodity Exchange Authority of the United States Department of Agriculture under the Commodity Exchange Act and conduct futures trading in some 22 commodities. The remainder of the exchanges deal in unregulated commodities, mostly imported

agricultural products such as coffee and cocoa and natural raw materials. The bulk of trading, however, is actually carried on by relatively few exchanges and in perhaps a dozen commodities. The largest exchange is the Chicago Board of Trade, which deals in a number of products including wheat and the other grains, soybeans and their products, and lard. Other leading exchanges include the Kansas City Board of Trade, the Minneapolis Grain Exchange, the New York Cotton Exchange, the New Orleans Cotton Exchange, the New York Mercantile Exchange (the principal futures market for potatoes), the Chicago Mercantile Exchange (the principal market for eggs), the New York Cocoa Exchange, the New York Coffee and Sugar Exchange, and the Commodity Exchange, Inc. (which deals in hides and certain natural raw materials).

The largest amount of futures trading occurs in wheat and in soybeans. During the fiscal year 1956–57, the value of futures transactions for each commodity approached $11 billion. Only five other regulated commodities exceeded one billion dollars in value of trading during the same year: cotton, corn, eggs, soybean oil, and rye. The total number of bushels of wheat bought and sold in the futures market in 1956–57 amounted to 4,885 million,[6] about five times the actual amount of the crop. Futures transactions in soybeans approached 4,500 million bushels, or some ten times total production. The most actively traded commodity, however, relative to production was probably rye; futures transactions amounted to approximately 40 times production. Thus trading on organized commodity exchanges has this distinguishing feature: that the total purchases and sales for future delivery may exceed greatly the amount of the commodity available for delivery. One reason for this, as will be shown later, is that relatively few deliveries actually take place on these futures contracts. Another is that the same commodity may be bought and sold many times during the course of a year.

Functions of Commodity Exchanges. The object of a commodity exchange is to facilitate the market activities of its members. It does not buy or sell products as an organization. But it provides a place in which trading can be carried on, and it governs the trading activities by rules and regulations. In addition, the exchange establishes uniform grades for products and a system of inspection, and acquires and disseminates market news. Trades can be executed on an exchange only by members of the exchange. Nonmember traders have their orders executed for them by brokerage firms which hold memberships in the various exchanges.

[6] For these and other statistics, see *Commodity Futures Statistics*, Statistical Bull. No 221 (Washington, D.C.: Commodity Exchange Authority, U.S. Department of Agriculture, December 1957), pp 3 and 5.

Trading on organized exchanges consists of two types of transactions: (1) the purchase and sale of futures contracts in the futures market, and (2) nonfutures trading, which refers to transactions made in what are usually designated as "cash" or "spot" markets. The distinction between these two types of trading lies primarily in the type of contract involved and in the definiteness of delivery. A cash or spot transaction involves the purchase and sale of a specific lot of the commodity of a specified type and grade with title to the lot being transferred at approximately the time of the sale; i.e., delivery is definitely made either immediately or at a designated time in the near future. For example, a flour miller who needs a specific type and grade of wheat for milling purposes may purchase this wheat through the spot market facilities of an organized exchange. Likewise, an exporter who has just agreed to sell a million bushels of No. 2 Hard Red Winter wheat to India may purchase this wheat through the spot market facilities of the Kansas City Board of Trade.

A futures contract in wheat, by contrast, represents a promise to buy and a promise to sell wheat "in general" with delivery provided for at some time during a specified future month but not necessarily taking place. The contract does specify a grade and type because these are necessary to establish a price. But the seller has the option, if delivery actually does take place on the contract, of delivering such other grades and types as are permitted by the exchange at price differentials that are also regulated by the exchange. Since the buyer cannot be assured of obtaining a specific grade and type of wheat through the purchase of a futures contract, the flour miller and exporter previously mentioned usually buy their specific types and grades of wheat through the cash or spot market rather than through futures contracts. They may have other reasons, as will be seen later, to deal in the futures market, but for the particular transactions illustrated here the spot market is the more appropriate.

It should be understood that cash or spot transactions in commodities need not be channeled through an organized exchange. The purchase of grain by the country elevator from farmers and its subsequent sale to terminal elevators are spot transactions which ordinarily do not involve the cash market facilities of organized exchanges. Terminal elevators also often sell directly to millers and exporters. However, the relationship of spot prices to futures prices on the organized exchange is of great importance in the purchase and sale of commodities and in hedging. Therefore, it is important for traders to make sufficient use of the cash market facilities of the organized exchanges so that such price relationships may be established.

It should also be noted that exchanges vary greatly in importance with

respect to spot and futures markets. For example, the Chicago Board of Trade is the major futures market for wheat with about 75 per cent of the total volume. The Kansas City Board of Trade is much less important as a futures market but handles a large amount of spot wheat. Thus a Kansas City elevator holding Hard Red Winter wheat would sell it through the spot market facilities of the Kansas City Board of Trade, but might well do its futures trading in the Chicago market because of the ability of the latter to absorb a large volume of business without an undue effect on prices. There are also a number of cities which are important spot markets for a commodity but which do not maintain futures trading facilities.

Futures Trading

The essence of futures trading on organized exchanges is that a contract is entered into by which one party agrees to buy and the other party agrees to sell a stipulated amount of a commodity at a price agreed upon at the time the contract is made but with delivery of the commodity to take place during a future period of time. In order to facilitate trading, standard contracts are provided by the exchange, and it is necessary for traders to utilize these contracts and to abide by the rules and regulations of the exchange. An understanding of the contract provisions is the first step to an understanding of futures trading.

Contract Provisions. As previously indicated, a certain type and grade of the product is specified as the contract grade, and the price agreed upon applies to that grade if delivery is made on the contract.[7] But since there may not be enough of that grade available for purposes of delivery, certain other grades specified by the exchange may be delivered at the option of the seller. Such grades are delivered at prices above or below that of the contract grade, as determined by fixed differentials laid down in the rules of the exchange or by market differences prevailing in specified cash markets on the day of delivery.

Contracts also specify standard quantities of the commodity, often an amount approximating a carload. In cotton the standard contract is for 100 bales (50,000 pounds), although a half-contract can be purchased on the New Orleans Exchange. In the grains, the regular contract constitutes 5,000 bushels, although units of 1,000 (2,000 fo oats) can be traded in the "job" or odd-lot market.

Futures contracts call for delivery, at the option of the seller, at any time

[7] On some exchanges, two or more types or grades may be specified as the contract grades.

during the futures month specified in the contract. Exchanges do not provide contracts for all months of the year. For example, wheat futures contracts are provided that mature during the months of July, September, December, March, and May; and soybean contracts mature during January, March, May, July, September, and November. Each of these months represents a different and distinct trading unit. Thus the purchaser of a December wheat contract knows that if he retains the contract until December the seller may exercise his option to deliver 5,000 bushels of wheat. The exact day of delivery will be determined by the seller, who must, however, give notice of intention to deliver a certain minimum time in advance. Delivery is made by presenting warehouse receipts carrying title to the stored goods.

The Mechanics of Trading. To illustrate the handling of a futures transaction, assume that a trader decides on August 5 to purchase 5,000 bushels of wheat. At that time, trading is being carried on in September, December, March, and May contracts. The December contract is selected and the trader orders his broker, who is a member of the Chicago Board of Trade, to buy one contract of December wheat at the market, i.e., at the going price at the time the order reaches the floor of the exchange. The order is transmitted in a few minutes, often a few seconds, to the broker's representative in the wheat "pit" and is immediately executed with another trader or a broker who has a similar order to sell December wheat. The order is executed at a price of \$1.98⅞ per bushel (prices of the grains being quoted in intervals of ⅛ of a cent).

Now let us look for a moment at what has taken place. The standard December wheat contract has been entered into by a buyer who has promised to purchase 5,000 bushels of wheat in December at \$1.98⅞ per bushel, a total purchase price of \$9,943.75. The seller of the contract has made a similar agreement to deliver wheat sometime during December at the same price.[8] The buyer does not yet own any wheat and the seller may or may not own any. The buyer believes that the price of wheat will go up before December and he has thus taken a "long" position. The seller may actually have wheat that he plans to deliver on the contract, or he may be hedging a purchase of cash wheat (this will be explained later), or he may believe that the price of wheat will decline and that he can buy back his contract at a lower figure. In the latter event, he has taken a "short" position in the

[8] Neither party has had to advance as yet either the wheat or the \$9,943.75 representing the cost of the contract. Each has had to provide a margin, probably about 10 or 12 cents per bushel or \$500 to \$600 for the contract, to signify his good faith and intention to carry out the agreement. If delivery takes place, the remainder of the purchase price will be advanced by the buyer. If delivery does not take place, no additional funds will be required. Commodity trading is thus an attractive speculation for some people since large profits *may* be made on small investments.

market by promising to sell something that he does not yet own but which he can acquire prior to time for settlement of the contract.

If both parties retain their contract until December, delivery of the wheat may take place. Trading in the December future will continue to a date established by the exchange, usually around December 20. But notices of delivery may be made by sellers starting on December 1, usually a day or so earlier in actual practice. If delivery is offered by the seller prior to the expiration of trading in the futures contract, the buyer may either accept delivery or he may sell his futures contract and retender the delivered wheat to another trader. Contracts held after expiration of trading are normally settled by delivery by the end of the month.

Actually most futures contracts are not settled by delivery of the commodity. Rather, an evening out process takes place whereby buyers sell their contracts prior to the delivery month and sellers buy back contracts. Thus in the present illustration, it might be assumed that the price of wheat declined during the month of August and that on August 22 the seller of the above contract purchased an equivalent contract at $1.95⅝ per bushel. Thus his profit on the sale and purchase amounted to 3½ cents per bushel, or $175 on the completed transaction (5,000 bushels × $.035). As of August 22 he is out of the market, his place having been taken, let us assume, by a new seller. In a similar manner, our August 5 buyer sells his contract, let us say, on October 10 at a price of $2.00¼, the price of wheat having risen during September and early October. His profit is 1⅜ cents per bushel or $68.75 for the contract (5,000 bushels × $.01375). In this particular illustration, both parties to the original contract made a profit, but at the expense, of course, of some other buyer or seller. The profit incidentally is reduced by the amount of the brokerage charges, $18 for each party. But the point to the illustration is that no delivery took place on the original contract because both parties evened out their positions prior to the settlement date, resulting in the cancelling of the contract.[9] It is likely that neither party intended delivery at the time the contract was made. In fact there may have been little reason for wanting delivery. As has been explained previously, the futures market is not a good source from which to obtain spot wheat since the grade cannot be specified by the buyer. Terminal elevators, however, often accept delivery inasmuch as it is their function to sell whatever wheat they can obtain.

[9] Some readers may be confused by the fact that, in our illustration, the August 5 buyer and seller evened out their transactions at different times and with other parties. This need not concern us in the present discussion. The parties to the original contract were relieved of their obligations as effectively as if they had again dealt with each other. Organized exchanges maintain a clearinghouse, somewhat similar to that maintained for settlements among banks, to keep track of long and short positions and to determine who are the parties to contracts at any given time.

The Purpose of Futures Trading. Futures contracts are entered into either for *speculative* purposes or to obtain *protection against risk.* Thus some traders buy or sell futures contracts because they believe they can make a profit. Such persons *assume risks* which they did not previously have and which they need not have incurred. They are known as speculators. But other traders buy and sell futures in order to *minimize the risk* of price change. Such persons are known as hedgers. Regardless of the purpose of one who deals in futures, the method of trading is the same.

For example, the sale of the August 5 wheat contract mentioned above may have been made by a speculator expecting a decline in prices. On the other hand, it may have been made by a terminal elevator which had just received a shipment of wheat from a country elevator. The cash or spot price paid for this wheat bears a certain relationship to the futures price. The terminal elevator does not have an immediate buyer for the spot wheat and does not know when it will find a buyer. If, during this time between the purchase and the sale of the spot wheat, the price of wheat should decline, the terminal elevator would lose money on the transaction. This can be largely avoided by selling a futures contract. When the spot wheat is finally sold to a miller or exporter, the futures contract is purchased. If the price of wheat has declined, the loss on the sale of spot wheat will be largely offset by the gain on the futures contract.[10]

Let us look for a moment at the buyer of the August 5 futures contract. It is very likely that he is a speculator who expects the price of wheat to rise. If the seller is indeed the terminal elevator mentioned above, then the speculator has assumed the risk of a possible price decline, a risk which otherwise would have to be assumed by the elevator. But not all futures contracts are purchased by speculators; business buyers also enter the market. Let us assume that an exporter on August 5 enters into a contract to sell wheat to India at the August 5 price for cash or spot wheat, delivery to be made to the port of shipment on September 10. The exporter does not yet own any wheat and

[10] Complete examples of several hedging transactions appear later in the chapter, but the transactions in this example, considerably oversimplified, might appear as follows:

Spot Market		*Futures Market*	
August 5 Purchased 5,000 bushels of wheat from country elevator at	\$1.90⅞	August 5 Sold 5,000 bushels of December futures at	\$1.98⅞
August 22 Sold 5,000 bushels of wheat to a miller at	\$1.87⅜	August 22 Purchased 5,000 bushels of December futures at	\$1.95⅜

The loss of 3½ cents per bushel on the spot transaction is made up by the gain of 3½ cents per bushel on the futures transaction.

will have to buy it from terminal elevators during the next two or three weeks. If the price should rise between August 5 and the date of purchase, he will lose money. To avoid this, he "covers" his export sale by the purchase of futures. As he arranges for the purchase of cash wheat during the next few weeks, he will sell his futures contracts. If price changes have taken place, his gain or loss on the cash market will be offset by a loss or gain in futures.[11]

One of the purposes of futures trading actually is to make possible hedging transactions which provide commodity merchants and processors a degree of protection from price fluctuations. Speculation is an incidental activity made necessary by the fact that there must be buyers and sellers available—the speculators—to provide an active market and to assume risks. Because of the intricacies of the hedging process, a more detailed discussion follows.

Hedging

Hedging is the executing of two simultaneous but offsetting transactions in two different markets. As we have already seen, in connection with the illustrations of the terminal elevator and the exporter, one transaction is a purchase and the other is a sale. The two markets are the cash or spot market and the futures market. The transaction in the cash or spot market is any purchase or sale, or contract to purchase or sell, which results in the delivery and transfer of title to a specific lot of wheat either immediately or at a future date.[12] The transaction in the futures market is the purchase or sale on an organized exchange of a standard contract for the commodity "in general," with delivery of some type and grade of the commodity being possible in the future but not necessarily likely to occur.

Purpose of Hedging. The purpose of hedging is to avoid risk and to insure, to the extent possible, the normal operating profit of the commodity merchant or processor. It is true that, by the use of a hedge, the hedger gives up the opportunity to make excessive profits, but by the same token he also avoids the risk of large and unnecessary losses. Assume that a terminal elevator in Chicago buys wheat from a country elevator at $1.90 per bushel when the Chicago cash price for resale by terminal elevators is $1.95. The differential

[11] The reader may raise the question of why the exporter does not buy cash wheat on August 5 rather than futures, since this would accomplish the same purpose and be even more certain. The reason is that it may take the exporter several days or weeks to locate the specified type and grade of cash wheat. But the futures market is so well organized that he can buy futures in a few minutes. Actually exporters do buy cash wheat in preference to futures when they are in a position to effect the cash transaction quickly.

[12] This may appear to be confusing to the reader, but it is important to realize that not all cash or spot transactions call for immediate delivery or transfer of title. For example, the export sale illustrated previously is a spot transaction on August 5 with delivery set for September 10.

of 5 cents represents the terminal operator's cost and profit. If he is successful in reselling the wheat at $1.95, he will make a normal and satisfactory business profit. If he resells at $1.99, he will make an additional "windfall" profit, because of the rise in price, of 4 cents. But if the price declines and he can resell only at $1.89, he will incur a substantial loss on the transaction. And a series of such losses may drive the elevator out of business. By hedging, the elevator operator gives up the opportunity of making a speculative profit on the wheat but does assure himself, to the extent possible, of his normal trade or operating profit.

A Short-Term Hedging Transaction. The hedging transaction is simple in theory but quite complicated in practice. The present discussion will not attempt to deal with many of the complications but will attempt to illustrate the basic theory.[13] Let us begin with an example of short-term hedging, using the situation set forth in the preceding paragraph. The terminal elevator on August 1 purchases 25,000 bushels of wheat from a country elevator at $1.90 per bushel when the Chicago cash resale price is $1.95 and the September futures $1.99. The purchase from the country elevator is a spot market transaction. To hedge this transaction, the terminal elevator sells 25,000 bushels of September futures contracts at $1.99. On August 6 the terminal elevator sells the wheat to a miller, the Chicago cash resale price at that time being $1.93. At the same time, it buys back the futures contract at $1.97 per bushel. The completed transactions appear as follows:

Spot Market		*Futures Market*	
August 1 Purchased 25,000 bushels of wheat at $1.90; Chicago cash equivalent being	$1.95	August 1 Sold 25,000 bushels September futures at	$1.99
August 6 Sold 25,000 bushels at	1.93	August 6 Purchased 25,000 bushels September futures at	1.97
Gain or loss from price change	−$0.02		+$0.02

Thus the loss on the cash market is equal to the gain on the futures market, and the elevator made 5 cents on the transaction to cover costs and normal operating profit, the difference between the actual purchase price of $1.90 and the Chicago cash price of $1.95 on August 1.

In the illustration shown, both the cash price and the futures price declined

[13] For a more sophisticated treatment of hedging, see Holbrook Working, "Futures Trading and Hedging," *American Economic Review*, June 1953, pp. 314–43.

by 2 cents between August 1 and August 6, thus permitting a perfect hedge. If the two prices had not moved together, the elevator would have had a speculative gain or loss on the transaction, but probably not so much of a gain or loss as if it had not hedged. Perfect hedges are the exception rather than the rule, since cash and futures prices do not usually change over a period of time by exactly the same amounts, but there is a tendency for them to move together. To explain why this is true, it is necessary to first understand the nature of carrying charges and the "basis."

The Basis. The difference between the cash price and the price of the nearby futures is called the "basis." In the above illustration, the basis on August 1 was 4 cents ($1.99–$1.95) and on August 6 it was still 4 cents ($1.97–$1.93).[14] Thus a perfect hedge was executed. But what does the basis represent and why is it a specific figure? The basis tends to equal the costs of carrying and storing grain to the futures month. That is, at any given time the price of the nearby future should be higher than the cash price by approximately the cost of carrying the commodity to the futures month. Moreover, the difference between the futures price for a distant month and the futures price for a nearby month, which is called the "spread," should also equal carrying charges between the two months.[15]

The following illustration shows the prices of wheat as they should be on August 1 if carrying charges amount to 2 cents per bushel per month and if the September futures price is $1.99:

September futures price is	$1.99
Carrying charges for August and September = 4 cents; so August 1 cash price is	$1.95
Carrying charges for October, November, and December = 6 cents; so December futures price is	$2.05
Carrying charges for January, February, and March = 6 cents; so March futures price is	$2.11
Carrying charges for April and May = 4 cents; so May futures price is	$2.15

Now if the reader were to look in the newspaper for the current wheat price quotations of the Chicago Board of Trade, he probably will not

[14] As a matter of fact, cash prices are customarily quoted in terms of the nearby futures contract. Thus cash wheat in the illustration would have been quoted not at $1.95 or $1.93 but at 4 cents under September futures. As the futures price changes momentarily, the cash price also changes, but the basis is likely to remain constant for a day or several days or even longer.

[15] There is a tendency in marketing literature to use the term "spread" to include both the basis between cash and futures and the spread between two futures months. The terminology actually used in commodity markets is usually as given here.

find so regular a relationship. In fact, May wheat is often quoted at less than March wheat. There are many reasons for this situation, but essentially it is due to the fact that each month is actually a separate market and that markets are imperfect. Furthermore, the fact that delivery on futures is at the option of the seller as to grade and type makes some persons reluctant to hold futures contracts even if it appears that such holding should be profitable.

Suppose in the above illustration that the September future is selling at \$1.99 and cash wheat at \$1.90, a discount of 9 cents instead of the expected 4 cents. Any person could then buy cash wheat at \$1.90, sell futures at \$1.99, deliver the cash wheat on the September futures at the end of September, pay 4 cents for carrying charges, and make a clear profit of 5 cents. Similar arbitraging transactions can be carried on in March and May wheat if these prices should get out of line in the same way. Since these transactions are relatively easy to carry out, there is a definite tendency for the basis and the spreads not to exceed carrying charges by a significant amount.

The reverse transaction, however, is somewhat more complex. Assume that cash wheat on August 1 is selling at 2 cents above September futures, or at a premium of 6 cents in relation to carrying charges. The natural arbitraging transaction is for the holder of cash wheat to sell it immediately at the premium price, buy September futures, and wait for delivery on the futures contract. At the end of September, he would have replaced his stock of cash wheat and would have a profit of 6 cents on the entire deal. There are two barriers to this transaction. The first is that only those who already own cash wheat on August 1 can enter into it. Those who might attempt to buy cash wheat for the purpose of immediate resale will undoubtedly find it difficult to do so, since the premium price in itself indicates that cash wheat is in short supply. The second barrier is that the wheat delivered in September will probably be inferior as to grade and type and may actually be difficult to resell.

Thus there is often some hesitancy to enter into this type of transaction, and it is possible for the basis and the spreads to reflect less than full carrying charges over a considerable period of time. This is particularly true if cash wheat is in short supply at the moment, but it is believed that more will be available at a later date; e.g., redemptions from government loan will take place or farmers are merely waiting for the new tax year before selling. Accordingly, price relationships between cash and futures or between two futures months do not always reflect carrying charges and hedges are not necessarily perfect. However, to show the effect of carrying charges on hedging, it is now necessary to examine a long-term hedging transaction, i.e., one involving several months.

A Long-Term Hedging Transaction. Assume a terminal elevator buys cash wheat on August 1 and hedges in December futures. Carrying charges are 2 cents per bushel per month. The September futures price is \$1.99, the basis is 4 cents under September or \$1.95 for cash wheat, and the December future is \$2.05—the same figures previously used. The cash wheat is sold on December 1. At that time the December futures price is \$2.07 and the basis 2 cents (carrying charges for the month of December), making a cash price of \$2.05. The cash wheat has been stored for four months (from August 1 to December 1) and carrying charges have thus amounted to 8 cents per bushel. The completed transactions are as follows:

Spot Market		*Futures Market*	
August 1 Purchased 25,000 bushels of wheat, Chicago cash equivalent being	\$1.95	August 1 Sold 25,000 bushels December futures at	\$2.05
December 1 Sold 25,000 bushels at	2.05	December 1 Purchased 25,000 bushels December futures at	2.07
Gain or loss from price change	+\$0.10		−\$0.02
Carrying charges on cash wheat	−\$0.08		

Two things are evident from this example. The first is that the basis, or discount of cash price to futures price, tends to narrow as the futures month approaches. In fact, late in December, cash and futures prices should be virtually identical because cash wheat is likely to be delivered on those futures contracts which are still outstanding. The second point is that, if cash and futures prices maintain their proper relationship, changes in the basis will give the hedger of stored wheat his carrying charges. It is for this reason that hedgers are sometimes called "speculators on the basis." It makes no difference whether prices go up or down. It is the narrowing of the basis that determines the success of the hedge. In the above illustration, the basis narrowed from 10 cents (\$2.05–\$1.95) in August to 2 cents in December (\$2.07–\$2.05), and the hedge was perfect since carrying charges were 8 cents. If the basis had changed from, say, 10 cents to 1 cent, the hedger would have made a "windfall" profit of 1 cent (9 cents change in basis minus 8 cents carrying charges). On the other hand, if the basis had changed from 8 cents to 2 cents, he would have lost 2 cents on carrying charges (6 cents change in basis minus

8 cents carrying charges). Depending upon the price changes that actually take place, such a loss may be a better result than if the operator had not hedged, but he would have been still better off not to have purchased wheat in August at all.

Of course, elevators have to buy wheat during harvest because this is their business. But if the basis at this time is very narrow, say 1 or 2 cents, or if cash wheat is actually selling at a higher price than the nearby futures, they are not likely to hedge their cash purchases. The reason is that there is little room for the basis to narrow and little opportunity to cover carrying charges through hedging. In fact, the basis may widen and an additional loss result. Hedging by elevators then takes place most often when the basis at harvest time is wide and there is ample opportunity for it to narrow prior to the advent of the futures month.

Other Illustrations of Hedging. The illustrations used thus far have involved hedging by terminal elevators, since these agencies make frequent use of hedging when conditions are favorable to it. Other agencies which may also engage in hedging include the country elevator, the processor, and the exporter. In general, the theory and practice involved is the same for these agencies as it is for the terminal elevator, although the circumstances involved may be somewhat different.

Country elevators have basically the same situation as terminal elevators. They buy wheat from farmers and may desire protection from price fluctuations between the date of purchase and the date of sale. If so, they sell futures at the time cash wheat is purchased and buy back the futures when the cash wheat is sold. Country elevators do not usually hedge to the extent that terminal elevators do. For one thing, they are not as familiar with the futures market and as close to it as are the terminal elevators. In addition, they have less need for the protection. Country elevators tend to sell the wheat they buy to terminal elevators within a relatively short period of time, thus transferring the risk to the latter. Moreover, grain is sometimes merely held for growers' accounts with the specific objective of obtaining a higher price at a later time. In this case, the elevator assumes no risk, and in any event hedging is not appropriate to the objective. When the country elevator finds it necessary, however, to hold wheat for an indefinite period of time, hedging is quite appropriate and may be utilized.

The processor has a somewhat different outlook. He is even more interested in many instances than is the terminal elevator in protecting his trade profit. Thus if a miller buys wheat in September to manufacture into flour that will be sold in April, he may well decide to hedge the transaction by selling

wheat futures. If wheat declines in price between September and April, the price of flour will also decline and a loss will result unless the hedge has been effected. In addition, if the basis and spreads are as they should be, the hedge will pay carrying charges and storage costs until the time the flour is sold.[16]

The processor also may have occasion to hedge in another way. Assume that he makes a forward sale of flour in advance of actual production and before the necessary wheat has been purchased; that is, he sells flour at the current price in December for delivery in April. If the price of wheat increases prior to the time it is purchased, a loss will result since the current price of flour is based on the present price of wheat. In this situation, the miller will buy May wheat in the futures market to cover the sale of flour. When he buys the cash wheat, say in February, he sells the futures contract. A theoretical illustration, in which carrying charges are assumed to be 1½ cents per bushel per month, follows:

Spot Market		*Futures Market*	
December 1 Sold flour at price based on present cash wheat equivalent of	$2.00	December 1 Purchased equivalent amount of May futures at	$2.09
February 1 Purchased cash wheat for flour contract at	2.05	February 1 Sold equivalent amount of May futures at	2.11
Gain or loss from price change	−$0.05		+$0.02

In this illustration, the basis reflects full carrying charges of 9 cents in December (six months times 1½ cents per month) and 6 cents in February (four months times 1½ cents). Thus the basis has narrowed by 3 cents as would be theoretically expected. There appears to be a loss of 3 cents on the transactions, but the miller would have lost 5 cents had he not hedged—the difference between $2.00 and $2.05 in the spot market. In reality, the illustration represents a perfect hedge. The miller is merely paying the carrying charges of 3 cents just as though he had purchased spot wheat on December 1 and stored it until February 1. He has without doubt covered this cost in the price of the flour sold on December 1. Thus hedges can be made through the purchase of futures as well as through the sale of futures.

The exporter also makes use of this latter type of hedging transaction.

[16] The reason for buying wheat in September is that the miller can obtain at that time the type and grade desired and assure himself of having a supply of raw material.

In a previous illustration, it was assumed that an exporter entered into a contract on August 5 to sell wheat at the August 5 spot price for delivery on September 10. This represents a forward sale of wheat and is the same type of transaction as the forward sale of flour just described. The exporter can protect himself against a rise in price by buying futures on August 5 and selling the futures as he accumulates spot wheat with which to fulfill his export contract.

The Role of the Speculator

The foregoing discussion indicates something of the nature of hedging and its benefits. There can be little doubt that hedging is beneficial to businessmen who desire to minimize the risk of price fluctuations and that hedging would be impossible without speculators. At the same time, there is a certain amount of criticism of speculation and speculators, especially when prices on organized exchanges are rising or falling rapidly. It is then alleged that speculation in futures contracts leads to greater price fluctuations than would otherwise take place, that abuses exist, and that organized speculation is detrimental to the economy.

In evaluating these criticisms, it must first be realized that hedging would be impossible if it were not for the presence of speculators. They are the ones who assume the risks and who provide the market for futures contracts that makes for efficient hedging. Effective hedging operations require a broad and liquid futures market capable of absorbing a large volume of transactions in a single day. If markets were restricted to hedgers, there would be certain seasons of the year during which the number of persons desiring to sell would far exceed the number desiring to buy and other seasons when the reverse would be true. The result would be that futures prices would fluctuate even more than they do at present, and hedging would be impossible to effect at an acceptable and logical difference between spot and futures prices.

Speculative trading in futures is not a major cause of either high or low prices. Essentially it is a method of arriving at a price and of distributing risk.[17] There may be times when speculators misjudge the future market for a product or overemphasize the possible effects of natural market conditions, such as drouth, upon a growing crop. At such times, the prices of futures contracts may rise and fall rapidly. But these are generally temporary fluctuations which have little effect on the eventual spot prices paid for the commodity. In the long run, speculative trading in a wide and continuous futures market tends

[17] See Roland S. Vaile, "Speculation and the Price of Grain," *Journal of Marketing*, April 1948, pp. 497–8.

to stabilize prices and aids in regulating the rate at which the year's crop is consumed. Prices at harvest time tend to be low and would probably drop even lower were it not for the speculators who purchase futures contracts when they consider the price to be "right." This permits merchants and processors to purchase on the spot market and hedge the transactions in futures. Because they can shift the risk of further price decline, they can afford to buy and hold the crops on a smaller profit margin than would otherwise be possible.

Speculation then is more likely to lead to price stability than to instability. Speculators must be alert to the basic economic forces that determine price. Since they are very likely to be informed on the existing conditions of demand and supply, they tend to be in a good position to evaluate existing prices. Thus, if prices decline more than appears to be warranted, speculators will tend to buy and thus arrest the decline. If prices rise too far, they will tend to sell. There are undoubtedly occasions when speculators take the lead in starting a price rise or a price decline because they have noted conditions of supply or demand not yet apparent to others. But the conditions of supply and demand are responsible for the price changes, not the speculators. In fact, the price adjustments may take place more gradually in this situation than would have been possible had all market factors noted the changed conditions at the same time. Actually, speculative traders in futures "have no power to withhold anything from the market and thus they merely reflect an estimate of future prices without either raising or lowering the level." [18]

Many of the criticisms of speculation should really be directed against manipulation of the market, an illegal activity under state and federal laws as well as under the rules of all organized exchanges.[19] There are two principal ways by which traders may attempt to manipulate a futures market. One is to send out false news of market conditions. The other is for certain operators, whose actions are carefully watched by other traders, to carry on operations opposed to the correct trend of the market. By such means it is hoped to stampede the market in the wrong direction so that when the normal forces do begin to function the manipulators, by changing positions quickly and perhaps secretly, can gain a larger profit. As stated previously, manipulation is illegal and, under modern methods of reporting and checking transactions on organized exchanges, a somewhat difficult practice in which to engage. It still exists, however, particularly in commodities which attract relatively few traders and have a limited number of transactions.

[18] *Ibid.*, p. 498.

[19] Julius B. Baer and Olin G. Saxon, *Commodity Exchanges and Futures Trading* (New York: Harper, 1949), p. 82.

CONCLUSIONS ON MARKETING RISK

Although some risks can be insured and others can be hedged, many business risks cannot be profitably shifted but must be borne by businessmen. The manufacturer and the wholesale merchant may shift some risks by offsetting contracts to sell with contracts to buy, and vice versa. Some farmers may contract to sell their output before production begins. But most goods are produced, and most purchases by middlemen are made, in anticipation of demand. If that demand fails to materialize, a loss is suffered.

In directing industry, the entrepreneur borrows capital, employs labor, and buys materials. He agrees to pay for all of these, whether or not he is able to sell the resulting product or service at a profit to himself. Of course, those who furnish capital, labor, and materials may also lose, but not until the law is satisfied that the debtor has paid to the full extent of his ability. So long as he is able to pay, it is the entrepreneur who bears the risks of business. He is willing to bear this risk because the expected profit is a sufficient inducement to counteract the chance of loss. Such risk, consequently, as cannot be eliminated or profitably shifted is borne by entrepreneurs. Even risk which is shifted, unless it is offset by a contract of an opposing character, such as the hedge, must be borne by the one to whom it is shifted. In the end all the losses that result from market risks must be borne by someone. By the means which have been discussed, however, many of these risks are removed or minimized and still others are divided.

QUESTIONS FOR DISCUSSION

1. In view of the complexity of the material on futures trading and hedging, it is unlikely that the average class will have time to discuss additional issues. One topic not treated in the text discussion, however, is whether the farmer could benefit by futures trading and hedging. Generally speaking, the farmer does not hedge. If he likes the price existing at harvest time, he sells his crop immediately; otherwise he holds for higher prices. Can you think of situations in which it would be desirable for a farmer to hold his crop and hedge (sell) in the futures market?
2. It is not unusual for July and September grain futures prices to reach their high point in the March or April preceding harvest and then to decline until harvest is completed. If these prices are sufficiently high that a farmer desired to be assured of receiving them for his harvested crop, what actions would he take in the futures market and when?

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24. MARKET INFORMATION

Market information includes all facts, estimates, opinions, and other information used in making decisions that affect the marketing of goods and services. It includes such diverse elements as weather reports and weather forecasts, which may affect the prices of agricultural commodities on the futures markets or the day-by-day merchandising plans of a local retailer; reports, analyses, and forecasts of business conditions, which may determine the merchandise to be ordered today by a wholesaler or the basic marketing plan of a manufacturer for the ensuing year; brand preference and other product studies which give the seller information regarding the purchasing habits and product preferences of buyers; and motivational research studies which attempt to provide answers to the question of why consumers act as they do. These are only a few of the types of market information available to and sought by those who perform marketing functions. The variety of information needed for decision making in marketing is so great as virtually to stagger the imagination: information regarding products, prices, markets, middlemen, selling methods, and other elements of the marketing mix.

Once the problem or objective has been defined, the first step involved in the function of market information is its collection. Someone obviously must obtain the information and assemble it. Secondly, the information must be communicated and disseminated to those who have need for it. Third, it must be carefully interpreted and wisely used. Thus a good system for the collection and communication of market information is essential in modern marketing. But this by itself is not sufficient. The available data must be carefully interpreted in terms of the problems to be solved by those who use the data, and decisions must be made in the light of the plans and policies of the particular firm or person involved. This is the final objective in utilizing market information: to make decisions based on a careful interpretation of available facts and to put these decisions into effect.

IMPORTANCE OF MARKET INFORMATION

To the extent that the services involved in the collection, communication, and interpretation of market information are perfected, accurate forecasting is more likely to occur with respect to selling and buying activities. Thus the influence of a major cause of market risk is minimized. By minimizing risk, market information makes the problems involved in market finance less difficult of solution. Loans can be made and credit extended on sales with greater certainty of normal repayment, and investments in stocks of commodities and the expenses of sales campaigns may be reduced because they are attended with less risk.

Market information has a particularly important place among the factors that determine what is produced and consumed, and hence among the factors that determine prices. It is assumed that in a competitive economy the forces of demand and supply tend constantly toward an equilibrium. But as markets grow in size and as products and production methods become more complex, information concerning demand and supply must be carefully collected and interpreted if this equilibrium is to be in any measure realized. It is, however, these very conditions in modern industry that make market forecasts difficult and often inaccurate, and so cause failure of individual business firms.

Recognition of the importance of market information and its interpretation as a basis for making business decisions has caused business organizations in increasing numbers to engage in market research activities and to employ specialized market research agencies to supplement their own efforts. Indicative of this is the fact that 60 per cent of 1,214 business organizations responding to a survey conducted by the American Marketing Association reported the existence of formal marketing research departments in 1957.[1] More than half of the 730 such departments had been organized since the end of World War II. Expenditures for market research were not reported by all of the 1,214 respondents, but 861 organizations—of which 653 had formal departments—reported expenditures of almost $75 million for market research in 1957. Impressive as this may sound, it should be realized that the expenditures in almost all companies amounted to only a fraction of one per cent of sales. Moreover, it is well known that the amounts spent for industrial research in the United States are much greater than the expenditures for marketing research. Considering the fact that the cost of marketing is approximately equal to the cost of producing goods, it seems logical to believe

[1] *A Survey of Marketing Research* (Chicago: American Marketing Association, 1959).

that much larger sums should be spent on private marketing research. No doubt there will be continued expansion in this field.

The demand of businessmen for more information to use as a basis for their own research efforts has also brought pressure on governmental agencies, universities, private foundations, trade associations, and trade journals to gather more comprehensive and more accurate basic data. Our national government offers what is by far the largest single source of market information in this country through the annual, periodical, and specific reports of its many bureaus and departments. The efforts of these governmental agencies and of other important agencies that collect and disseminate market information constitute an important portion of the subject matter of the following section.

COLLECTING MARKET INFORMATION

The problem of collecting market information may be approached by the business executive basically in three ways. The first source of information, and the logical starting point in marketing analysis, is the information that can be derived from the company's own records. Sales data of the firm itself constitute the data most pertinent to the company's operation. Moreover, such information can be collected rather easily and with relatively little expense. Analysis of internal records, however, seldom provides complete answers to all of the marketing problems of the firm.

After the executive has obtained all relevant internal data, he should proceed next to the published information available from external sources. Although unpublished information can sometimes be obtained from such sources, most of the data are to be found in the published reports of governmental bureaus, trade associations, and the other agencies mentioned in the preceding section. Such information is relatively inexpensive to obtain, although a good deal of searching may be necessary to uncover it. Moreover, since these data are usually collected for general use, they may not be presented in the proper form or insufficient detail to reveal the specific information that is being sought by a particular firm.

Accordingly, it is often necessary for a company to make a special effort to obtain desired information. This may be done through its own marketing research program, which constitutes the third source of market information. Data obtained through original research are usually more pertinent to the company's situation than are those obtained from external sources. Their collection, however, is likely to be expensive, and most small firms feel that they are financially unable to engage in original marketing research. Further-

more, the methodological problems involved in original research are complex, and great care must be taken to avoid biases that will lead to inaccurate results and conclusions. Some of these methodological problems will be discussed at a later point in this section.

Analysis of Internal Records [2]

A firm's own records, especially the sales records, constitute a very important source of market information to that firm. Even though the nature of a specific marketing problem indicates that external sources should be checked or that original marketing research will be necessary, analysis of the internal data—commonly designated as "sales analysis"—may assist greatly in locating and defining the exact problem. Moreover, detailed analysis of the sales records will reveal many trends that would otherwise remain unnoticed. Three of the more important phases of sales analysis include product analysis, territorial analysis, and customer analysis. Classifying sales, costs, and profits according to these three bases can furnish a great deal of management information.

Product Analysis. Most business firms in the United States, even small ones, are multiproduct organizations. They are likely to sell several product lines, or at the very least various sizes and types of a single line. But these various product types do not necessarily sell at a uniform rate. An analysis of the total sales volume of a firm, let us assume, indicates an increase of 10 per cent in relation to the corresponding period a year ago. Everything seems to be going well and the company is satisfied with results. A breakdown of sales by product lines, however, reveals that three lines have increased in sales by considerably more than 10 per cent, whereas a fourth has had an actual decrease of 25 per cent. Although the fourth line in the past has accounted only for 15 per cent of total volume, a cost analysis—also made from company records—indicates that one third of the total gross profit of the firm has been derived from the sale of this product. Thus a problem is revealed. Further investigation will be necessary to determine the cause of the decline and the remedy, but without sales analysis the management of the firm might not even have known of the existence of the problem until possibly too late to take proper remedial action.

Territorial Analysis. Differences in the rate of sale may also be analyzed by sales districts or territories. This is perhaps the most widely used form of

[2] For good discussions of this topic, see Richard D. Crisp, *Marketing Research* (New York: McGraw-Hill, 1957), Chap. 6; and Jack Russell, "A System of Sales Analysis Using Internal Company Records," *Journal of Marketing*, April 1950, pp. 675–90.

sales analysis, since most business firms assign salesmen more or less to a specific territory and establish a district or regional manager to supervise the efforts of a number of territorial salesmen. The analysis of sales by territories, districts, and regions thus gives top management a measurement of salesmen's performance as well as a geographical sales pattern. Weak territories can be located and investigation made to determine the cause of the weakness. Many firms attempt to establish sales potentials and quotas for each territory and then compare actual sales results with these potentials or quotas.[8] Product analysis may be combined with territorial analysis to show sales trends of the various product lines by sales districts.

Customer Analysis. Customer analysis is best adapted and most widely used in the marketing of industrial goods, since the number of buyers or customers is small. Sales records can be compiled for each customer showing the frequency of order, the amount of goods sold, the particular product lines purchased, and other pertinent information. A periodic examination of these records will show any important change that has taken place in the status of a customer, such as a decrease in his purchases either over-all or in a specific product line, and will permit an investigation to be made. Customer accounts can also be analyzed as to profitability and appropriate action taken. More intensive sales effort can be directed to the more profitable customers while curtailing salesmen's calls on the less profitable. Orders may even be refused from those customers whose accounts are consistently and definitely unprofitable, with a resulting improvement in the net profit position of the seller.

Conclusions. These are only a few examples of the types of information that can be obtained from company records, but they should suffice to indicate the importance of this source of information. In order to interpret properly the data contained in sales records, it is often necessary to seek other sources of information. For example, the seller cited above, who discovered that his sales of the fourth product line had decreased by 15 per cent, would immediately want to know if this were true throughout the industry. He probably would seek the information first from external sources, i.e., industry statistics published by the government or by a trade association. If not available from one of these sources, it might be necessary for the seller to conduct his own market investigation. The collection of information from

[8] Territories may vary greatly as to sales potential for a given product. For example, the sale of antifreeze depends upon the severity of winter weather, as well as upon the number of automobiles and the levels of income of their owners. Thus a comparison of the sales volume of antifreeze by territories is not very meaningful unless territorial potentials are first established.

external sources will be discussed next, after which some time will be spent on the collection of information through original marketing research.

External Sources of Information [4]

It is not possible in the space available here to designate all of the external sources of market information. Even if it were possible, it would hardly be desirable to do so since the discussion would soon be out of date. New sources of information are constantly being made available to businessmen. In addition, specialized problems may well require specialized information which will be obtainable only after considerable searching in a good public or university library or in the various guides to marketing literature such as the *Business Periodicals Index*. It is possible, however, to point out some of the more common sources of information used by businessmen and to designate some of the agencies that may be in a position to furnish special information upon request.

Governmental Sources. As stated previously, the federal government constitutes the most important single source of market information. In addition, state and local governmental units often have data available that are very useful in the solution of specific problems. Such data vary greatly in quality and quantity, as well as in availability to the general public. Often special efforts are necessary to obtain such information. Consequently, the present discussion will be confined to the reports of the federal government, but any marketing executive with a problem to solve should not overlook the possibility that other governmental units may have pertinent information.

United States Department of Commerce. The Bureau of the Census is perhaps the most important source of marketing data in the federal government. The Census of Business gives information regarding retail trade, wholesale trade, and service establishments and is the source of much of the statistical information presented in the earlier chapters of this book.[5] Since data on number of establishments and sales volumes are presented by kinds of business for regions, counties, and cities, the census reports are very valuable to businessmen in locating markets and outlets, in establishing sales potentials and quotas by geographical units, in allocating advertising effort, in evaluating channels of distribution, and in many other respects. Other

[4] The term "secondary" sources of information is sometimes used here. For more complete discussions of this topic, see in particular David J. Luck and Hugh G. Wales, *Marketing Research* (Englewood Cliffs, N.J.: Prentice-Hall, 1952), Chap. 4; and Richard D. Crisp, *op.cit.*, Chap. 7.

[5] The Census of Business was first taken in 1930 for the year 1929. Subsequent reports have been made for the years 1933, 1935, 1939, 1948, 1954, and 1958. Under present law, beginning with 1958, census data are compiled every five years.

types of information are also presented in the regular reports of the Census of Business, and special tabulations of data to meet specific research and informational needs are often made by the Bureau.[6]

In addition to the Census of Business, there are also available from the Bureau the Census of Population, the Census of Housing, the Census of Agriculture, the Census of Manufactures, and the Census of Mineral Industries. All of these contain information of obvious value to marketers. Personal income information on a sample basis is also collected in connection with the decennial Census of Population. In addition, the Bureau of the Census obtains interim population data on a sample basis and makes this information available periodically through the various series of *Current Population Reports*. Finally, the *Statistical Abstract of the United States*, compiled annually by the Bureau, makes available in one volume a wide variety of data of interest to marketing men.

The Department of Commerce also engages in many other activities that provide marketing information to business. The Office of Business Economics gathers information regarding the basic economic measures of the national economy, current analyses of the economic situation and business outlook, and the balance of international payments. For example, the Office's National Income Division provides information of great significance for marketing with respect to various income measures, consumer and business expenditures, and measures of the output of the economy as a whole and of its various parts. The *Survey of Current Business*, published monthly, together with various special supplements report these and other data. Special reports on marketing and marketing research are also issued from time to time. To help businessmen locate specific sources of information, the Department publishes monthly *Distribution Data Guide* which lists recent marketing publications both private and governmental, and maintains 33 field offices throughout the United States which render assistance to anyone looking for specific types of data.

United States Department of Agriculture.[7] The collection and rapid communication of market information regarding agricultural products has long been recognized as a problem requiring governmental assistance. The scattered nature of agricultural production has made product information particularly difficult to collect, and the small scale of farm operations has made it impossible for individual growers to collect it through their own

[6] A special charge is made, of course, to cover costs.

[7] For more complete discussions of agricultural market information, see Richard L. Kohls, *Marketing of Agricultural Products*, 2nd ed. (New York: Macmillan, 1961), Chap. 15; and *Marketing: The Yearbook of Agriculture, 1954* (Washington, D.C.: U.S. Government Printing Office, 1954), pp. 170–9.

efforts. Even manufacturers and middlemen who use and sell farm products find it difficult, and certainly expensive, to collect information directly. Accordingly, the Department of Agriculture, in cooperation with state agencies, has long engaged in the collection and dissemination of agricultural market information. The performance of this function is now centralized in the Agricultural Marketing Service, a division of the Department.

A large part of the work of the Agricultural Marketing Service is concerned with the collection and distribution of current information, or market news, for more than 150 agricultural products: statistical information on crop and livestock production, on market movements of products, and on prices. Crop reports, for example, are used to estimate future conditions of supply. They include, first, estimates of the intentions of producers to plant; later, the acreage actually planted; and finally, the condition of growing crops and estimated total production from time to time during the season. Yield per acre, final production, prices realized by growers, value of crops at the farm, stocks on hand at the farm and in other positions, current shipments out of important growing areas, and current receipts at important wholesale markets are illustrative of the other types of market news also reported. For some products, market news reports are issued daily showing supply, demand, movement, and prices in terminal markets and, during the shipping season, in important producing areas.

Most of the above information is collected from cooperating reporters throughout the country: farmers, processors, and middlemen who fill out questionnaires and return them to state offices. Here the returns are checked and tabulated, last minute field checking is done if necessary, and county estimates are finally prepared and forwarded to the national office. At the latter, state and national estimates are compiled and finally released. In addition, railroads furnish information on shipments and arrivals to and from important markets, and warehousemen report on the volume of stored commodities. From many sources, therefore, comes the information that is finally released by the Market News Service in a variety of daily, weekly, monthly, and annual reports.

In addition to issuing these reports, the Agricultural Marketing Service attempts to interpret and appraise much of the information collected. These interpretations are contained in annual outlook reports and in such monthly and quarterly publications as *The Agricultural Situation*, *The Demand and Price Situation*, and *The Marketing and Transportation Situation*.

Finally, it should be noted that the Department of Agriculture also prepares and publishes specialized marketing studies. The functions of the Department in this respect were greatly extended by the passage of the Research

and Marketing Act of 1946, which substantially increased the financial support for research studies on agricultural marketing and marketing efficiency. As a result, the Agricultural Marketing Service published almost 400 marketing studies, called Marketing Research Reports, during the fifties. These reports contain much valuable information on specialized aspects of the marketing of agricultural products.

Other Federal Agencies. Although the Departments of Commerce and Agriculture are the chief governmental sources of market information for businessmen, there are many other federal agencies which contribute either regular reports containing data of specialized and general interest or from time to time make special studies of interest to marketers. Among these agencies are the following: the Bureau of Labor Statistics of the United States Department of Labor, which is noted particularly for information on the cost of living and for periodic studies on consumer incomes and expenditures; the Federal Trade Commission, which releases from time to time industry studies on marketing methods and costs; the Board of Governors of the Federal Reserve System and the Federal Reserve Banks, which publish the *Federal Reserve Bulletin* and other bulletins summarizing and interpreting business conditions; the Interstate Commerce Commission, the Federal Communications Commission, and similar regulatory agencies, which accumulate a considerable amount of statistical information in the course of their regulatory activities. Other governmental sources of marketing information could be mentioned, but these should be sufficient to illustrate the variety available.

Nongovernmental and Private Sources. A substantial amount of market information is also available from nongovernmental sources. This information varies greatly as to relevancy and even accuracy and must be carefully evaluated before it is utilized. Much of it is quite dependable but some is highly questionable. Only a brief sketch of the various sources will be attempted here. An experienced market analyst will make use of many others.

Trade Associations. Trade associations are an important source of information especially for manufactured products. There are several thousand such associations in the United States, many of which collect data from member firms as to sales, production, shipments, inventories, and other similar items. The individual company reports, which are not revealed, are combined into summary reports for the entire industry. To the extent that the information collected is complete and accurate, and this may vary considerably from one association to another, individual firms may compare their performance to that of the industry, determine the share of the market that they are obtaining, and evaluate market conditions at a given time. When adequate

and reliable data can be collected, trade associations may be of particular service in industries in which there are many relatively small competing firms. For, in such industries, either cooperative action or governmental assistance is required to obtain the information and to cover the cost of collecting, interpreting, and publishing it.

Local businessmen may also obtain valuable information from local and state associations, including chambers of commerce and credit men's associations. Such information may be statistical in nature or it may consist of reports of new methods and processes. Many chambers of commerce issue periodic reports with respect to local business conditions.

Trade and Other Periodicals. Trade magazines which serve a particular industry are a frequent source of market information of various types. Obviously, a principal function of an industry journal is to report on new products, methods, and processes, but many such publications also go to considerable expense to collect statistical information on an industry-wide basis. For example, the *Progressive Grocer* reports annually its estimates of retail food store sales by type of outlet, information which is not available elsewhere and which is widely quoted by the trade. Similarly, the *Oil, Paint, and Drug Reporter* collects and publishes for a wide variety of chemical products current price quotations which otherwise are not publicly available.

There are also trade periodicals which serve the marketing field generally rather than a specific industry and which are valuable sources of general market information. *Sales Management*, *Printers' Ink*, and *Industrial Marketing* constitute a few examples of the many such magazines that could be mentioned. Several of these, including *Editor and Publisher* as well as the three previously mentioned, publish special issues annually which contain various compilations of market data. One of the most widely used of these "market guides" is the annual *Survey of Buying Power* issue of *Sales Management* magazine, which is of particular value in determining territorial sales potentials since it estimates retail sales in considerable detail by geographic units.

A third source of periodical information is found in magazines and newspapers of general circulation. Reference here is not so much to the regularly published contents of these periodicals but rather to the special studies that they make in an effort to assist advertisers. An unusually good example is the *Study of Consumer Expenditures* of *Life* magazine referred to previously in Chapter 5. Another unusual example is that of the Curtis Publishing Company which has maintained a marketing research department for approximately fifty years to gather industry, product, and market information of value to advertisers. Other magazine publishers have followed in Curtis'

footsteps and have uncovered interesting market facts. Many studies, however, are confined to readers of the particular magazine and are of limited value. Finally, mention should be made of the brand preference studies of various newspapers. Originated by the *Milwaukee Journal* and widely imitated since World War II, these studies attempt to determine consumer preferences for the various brands of certain food and other products in the market area or principal city served by the newspaper. Careful study of the survey methodology used and of the results is necessary to evaluate the accuracy of these data. Studies of this type may be subject to a number of biases that will affect the results.

Other Sources. Bureaus of business and economic research now exist at many universities and are a source of market information of various types. Many such bureaus have developed statistical indicators of business conditions for the state in which they are located and publish regular reports showing changes in conditions. In addition, projects involving basic research are usually engaged in and the results published. The information developed from such research does not necessarily furnish a guide for immediate business operations but may be valuable in long-range planning.

There are also a number of private business firms and research organizations which collect and disseminate specific types of market information, usually for a fee. Examples include Dun and Bradstreet, Inc., a source of financial information and credit ratings for particular firms; the F. W. Dodge Corporation, which compiles statistics on construction; the R. L. Polk Company, which collects information on automobile registrations; and Daniel Starch and Staff, which makes surveys on the readership of magazines and newspapers for the benefit of advertisers. Even in the agricultural field, there are private crop reporting agencies which, although they are not considered as authoritative as the federal government, continue to find a market for their services because they are able to assemble information more rapidly or at more timely intervals than does the government.

One of the better known of the private market research agencies is the A. C. Nielsen Company which regularly "audits" a selected sample of retail stores to obtain sales data for specific food, drug, and other products. Information is furnished to each client regarding the rate of sale of his own brand and that of competitive brands. The significance of the information is that it gives the manufacturer a record of actual consumer purchases, which is often at variance with the manufacturer's own pattern of sales to wholesalers and retailers. Thus changes in consumer preference can be more exactly measured and more promptly noted than would otherwise be the case.

In addition, Nielsen is also noted for its reports on television viewing and radio listening.

Finally, a business firm can often obtain market information from another firm, especially from a supplier or an organization which sells complementary but not competitive products. Large manufacturing firms which maintain marketing research departments and develop much of their own market information are not necessarily reluctant to pass along some of this information to customers who request it for a specific purpose or to exchange information with noncompetitive organizations. There is perhaps more of this type of exchange than is generally recognized, and it should not be overlooked by one who is seeking data for a specific purpose.

Obtaining Information Through Direct Market Research

In many instances, business executives desire information about the market which cannot be obtained either from an analysis of internal records or from external data sources. In such cases they may resort to an original investigation of the market. That is, a specific market research project is set up, designed to obtain the exact information desired. Because of the technical problems involved in this type of research, the actual collection of information is often turned over to specialized marketing research agencies which have the facilities and trained personnel necessary to obtain accurate data. Many advertising agencies also maintain marketing research departments the services of which are available to clients.

Three basic methods or techniques are used in direct market research: the survey method, the observational method, and the experimental method. The following rather brief discussion attempts to point up some of the uses of, and problems involved in utilizing, these basic methods.[8]

The Survey Method. In the survey method information is obtained by asking questions of selected respondents. Thus it involves three principal methodological problems. The first is the nature and number of the questions to be asked so that accurate responses will be obtained. This may be termed the problem of questionnaire construction. The second is concerned with the method used to ask the questions and obtain the responses, the problem of questionnaire distribution. Answers to questions may be sought through the use of a mail questionnaire, through a telephone interview, or through a personal interview. The third problem is to select the proper respondents. In most surveys it is not feasible, because of the limitations of time and

[8] For a more complete discussion, see in particular Lyndon O. Brown, *Marketing and Distribution Research*, 3rd ed. (New York: Ronald, 1955), Chap. 5.

money, to ask the questions of all persons who might be qualified to answer. Therefore, a sample of respondents is selected to represent all respondents, i.e., the universe. In order for the survey to be reliable, the sample must be properly drawn in accordance with established statistical principles. This may be termed the problem of sample design.

Questionnaire Construction. The questions to be asked in a survey must be carefully chosen and properly phrased. Even questions involving simple factual information often are answered incorrectly: sometimes because of memory failure, sometimes because the question is misinterpreted, sometimes because the respondent is unwilling to answer accurately. For example, the question, "How much did you pay for your electric range?" may elicit incorrect responses. A person owning a range that is ten years old may not remember the cost. Another having bought an inexpensive model prefers not to reveal the price, or even worse reports one that is higher than the amount actually paid. Still another purchased the item at a discount house but reports the known list price of the manufacturer. A fourth was able to trade in an old range on the new one and reports the net amount paid, which may or may not be the answer sought by the questioner.

Good questionnaire construction requires that questions be stated in such a way that the meaning is clear to the respondents. The meaning of the question, "What kind of motor oil do you use in your car?" is not clear. "Kind" may refer to brand, weight, detergent or nondetergent, and other variables. In addition, "do you use" is not too specific. More accurate answers may be obtained by using the question, "What brand of motor oil do you have in your car now?" Questions should be of a nature that they do not lead the respondent to an obvious answer. For example, "Do you use Shell motor oil in your car?" is a leading question. The respondent desires to be agreeable, the questioner is obviously interested in Shell motor oil, and the respondent gives an affirmative answer. The more proper question, as stated above, will uncover fewer users of Shell oil than will this leading question.

Properly constructed questionnaires, devoted to carefully chosen subjects of investigation, may be used with some degree of confidence to obtain facts known to the respondents. They may also be used, although with somewhat less confidence, to obtain information about certain attitudes and opinions. Greater difficulties may arise, however, with surveys which seek to discover subjective reasons for consumer actions and attitudes. "Why did you buy this make of automobile?" and "Why do you shop at this particular store?" are examples of questions designed to uncover motivations. In addition to the ordinary limitations of the survey method, a new element of uncertainty is injected. Does the respondent really know the conscious and subconscious

motives and drives that led him to make a particular buying decision? In general, it may be doubted that accurate answers are obtained to motivational questions through ordinary survey methods.

Because of this fact, new research techniques have been developed since World War II which are designed to probe more deeply into the subconscious and to reveal more accurately the "real" motives underlying consumer behavior. Commonly designated as motivational research, these techniques involve depth interviewing, small samples, and the use of projective techniques adapted from the field of clinical psychology. There is still some difference of opinion as to the meaning of some of these terms, but the general approach of motivational research is to use a prolonged interview in which the respondent is encouraged to talk freely and at length in response to a variety of questions. In many instances, the questions revolve around a "projected" situation, such as a picture or a shopping list, and the respondent is asked to tell what things come to mind as a result of this stimulus. In the case of the shopping list, the respondent may be asked to characterize the type of woman who would purchase these products. By using different shopping lists, the interviewer may be able to determine consumer reactions to a particular product that would not be revealed by ordinary questionnaire methods. Word association and sentence completion tests are also used to reveal basic motivations. In view of the methods used and because of the greater expense of long interviews, relatively few respondents are interviewed—50 is perhaps a common number—in comparison with the more conventional types of surveys—in which several thousand interviews may be made.

One of the principal problems of motivational research is that of proper interpretation of results and the lack of uniformity in such interpretation. It is not unknown for two investigators to interpret similar findings in quite different ways. For this and other reasons, there has been considerable controversy regarding the value of motivational research. Its adherents have often claimed too much for it. It certainly is not a substitute for regular market research methods, and it does not provide answers to the questions of "how much" or "how many." It may, however, provide ideas and hypotheses with respect to consumer behavior. It may reveal reactions to products that are not otherwise obtainable. But it must be emphasized that trained personnel and skillful interpretation of the results are necessary to achieve maximum benefit.

Questionnaire Distribution.[9] Many questionnaires are distributed by mail with the request that they be filled out and returned. This is the most

[9] For a good summary of the advantages and disadvantages of the various methods of questionnaire distribution, see Richard D. Crisp, *op.cit.*, pp. 191–8.

economical method of distribution, provided that a satisfactory percentage of returns is obtained, and permits the sample to be drawn from a wide geographical area as easily as from a restricted one. More thoughtful answers are often provided to mail questionnaires than to other types since more time can be taken in filling them out, and answers to personal questions can often be obtained more easily since the respondent usually assumes that he is answering anonymously. On the other hand replies to mail questionnaires may be few in number, and the limited returns may well distort the original sample design. For many types of survey, moreover, there is no applicable mailing list available. Mail surveys are most likely to be made successfully when respondents are known to have an interest in the subject matter and when the questions are capable of being easily understood.

Surveys are also often made by telephone. The economy of this method is obvious, since the telephone interviewer can obtain interviews rapidly and with little travel, in comparison with the personal interview method. The telephone interviewer can also explain terms and probe for additional comments, a flexibility which is impossible to achieve in the mail survey. The telephone method, however, has one major limitation. A truly representative sample of the general population cannot ordinarily be obtained in this way, since some people do not have telephones. The telephone survey, therefore, is best adapted to communities which have a high ratio of telephone subscribers or to a class of respondents which is generally known to have telephones.

Because of the sampling limitations of the mail questionnaire and the telephone interview, it is often essential to use the personal interview method. The respondents chosen for the sample are sought out and the questions are asked directly by an interviewer who records the answers. In addition to the sampling advantage, the personal interview method also permits more information to be obtained than is usually possible in either of the other two methods. More questions can be asked, various types of subject matter can be included, and information can also be obtained through observation. On the other hand, the personal interview method is expensive and time consuming. An even greater problem is that of interviewer skill and honesty.[10] Interviewers must be carefully trained and supervised. Even so, many errors may be made. The failure of interviewers to follow instructions exactly may result in a distorted sample. Inaccurate answers to questions may arise as a result of the interviewers' ways of stating the questions. In addition, respondents' answers may reflect a desire to impress the interviewer, a bias

[10] For a good discussion of this topic, see Harper W. Boyd, Jr., and Ralph Westfall, "Interviewers as a Source of Error in Surveys," *Journal of Marketing*, April 1955, pp. 311–24.

that is difficult to eliminate in a face-to-face interviewing situation. Nevertheless, the personal interview conducted by experienced and well-trained personnel is usually considered to be the most reliable method of obtaining questionnaire information.

Sample Design. The selection of a proper sample of respondents from the total universe of possible respondents is a highly technical problem. About all that can be done in the present discussion is to point up its importance.[11] The problem, of course, is to obtain a sample which will have, insofar as possible, the same characteristics as the universe. The universe is usually composed of many diverse elements, for example, people of different ages, residents of communities of various sizes and of different geographical regions, persons of varying levels of income. These characteristics affect the responses that people make to certain types of questions. If the sample is biased, say, toward high income groups or toward residents of large cities or toward older people, the results of a survey may be very misleading.

To illustrate this point, let us assume that a survey of the smoking habits of college students is to be made at a specific university. There are 6,000 students enrolled of which 4,000 are men and 2,000 women. Freshmen number 2,000, sophomores 1,500, juniors 1,500, and seniors 1,000. It is likely that the smoking habits of the men differ from those of the women and that upperclassmen are more likely to be smokers than are the freshmen. The survey sample is to consist of 300 students, and no instructions are given to the interviewers regarding sample design. The interviewers decide that they can obtain interviews most easily by stationing themselves near two large classroom buildings which are used primarily for a number of basic introductory courses. They obtain the 300 interviews, the results are tabulated, and the findings are that only one fourth of the students smoke cigarettes and that the smokers' average consumption is one half package per day. Further analysis of the interview data, however, reveals that one half of the respondents are women (who constitute only one third of the universe) and two thirds are freshmen (who constitute only one third of the universe). The result appears to indicate a substantial bias toward the interviewing of nonsmokers, a bias which can be checked by making another survey and utilizing scientific sampling methods.

Obtaining a reliable sample is a major problem of the survey method. Many marketing research efforts result in misleading information because of sampling errors. The reason for this is not so much a lack of knowledge of

[11] There is a great deal of literature on the subject of sampling theory and practice. The various books on marketing research constitute a good starting point for the marketing student. See, for example, Harper W. Boyd, Jr., and Ralph Westfall, *Marketing Research: Text and Cases* (Homewood, Ill.: Irwin, 1956), Chaps. 8 and 9.

proper sampling methods; on the contrary, there is a great deal of information available on this subject. But it is more expensive and requires more time and effort to select a proper sample of respondents than to interview on a haphazard basis. Thus, in some instances, no real effort is made to select a sample even reasonably representative of the universe. In other cases, errors result from carelessness in carrying out the interviewing instructions. On the whole, modern sampling procedures attempt to leave as little as possible to the judgment of the interviewer and provide very specific instructions as to the choice of respondents. If these instructions are carried out and if the sample is properly designed in the first place, reasonably reliable market information should be the result. Otherwise, the information obtained may be completely worthless.

The Observational Method. It is obvious from the foregoing discussion that there are many possible sources of inaccuracy in the survey method. Some of these inaccuracies can be eliminated by substituting observation for the asking of questions. Thus, instead of asking people what brand of coffee they use, the field worker may make a pantry check of the brands actually in the home at the time. In some studies, observers are stationed in retail stores—or better yet, hidden cameras may be used—to watch and record the behavior of consumers as they select certain items. Traffic counts taken at proposed store locations constitute another example of observational research, as are shopping trips conducted by investigators who pose as customers for the purpose of checking on the actions of retail salespeople. Any research effort which relies upon the direct observation of phenomena is using the observational method.

The advantages of the observational method are that it is more objective and more accurate than the survey method. The inaccuracies involved in answering questions, such as memory failure and desire to impress the interviewer, are eliminated, as are the various sources of interviewer bias. Actual market behavior is recorded, not a second-hand and perhaps inaccurate report of such behavior. There is still, of course, the possibility of human error in the recording of what has been observed, but with trained observers this is perhaps a minor difficulty.

The observational method is usually, however, more expensive than the survey method. More time is likely to be required in obtaining information by observation than by interview, particularly if it is necessary for the observer to wait for the phenomenon to take place. A field worker, for example, observing the behavior of purchasers of frozen foods in a supermarket is likely to waste a certain amount of time, since all shoppers do not buy frozen foods. In addition, the utilization of the observational method usually does

not eliminate the problem of sample design. Not all behavior can be observed any more than it can be recorded by personal interview or by a mail questionnaire. Therefore, an adequate sample of the universe must still be selected.

Finally, the observational method by itself may not reveal all the information needed to make a marketing decision. Observation shows what people are doing but does not indicate why they are doing it. In many cases, the reasons underlying behavior need to be known before action can be taken. Accordingly, the observational method is often most useful when combined with other research methods and techniques.

The Experimental Method. The controlled experiment is the basis of a great deal of scientific research in many fields. In marketing, the experimental method is used to test various types of advertising and sales promotional plans, to determine prices, and to test new products and packages. For example, assume that a manufacturer desires to know which of three possible prices for a product would bring the greatest revenue. He could set up an experiment in which the product would be sold simultaneously in three different groups of stores with a different price in each group. A comparison of sales results in the three groups, providing the experiment were carefully controlled, would give him an answer to the question. Assume that another manufacturer has developed a new product. He desires to know whether this product will be purchased by consumers, how much advertising support will be needed to achieve a certain sales volume, and other similar information. Instead of launching a national marketing campaign immediately, he will first test the product and the advertising in a few selected markets and watch the sales results. If the test results are favorable, the national campaign may then be inaugurated with every reason to believe that it will be successful.

The value of the controlled experiment is obvious, and few large companies would introduce a new product at the present time without first test marketing it. However, controlled experimentation in other phases of marketing is not used to so great an extent as one might suppose.[12] In the first place, this type of research is expensive. Secondly, it often takes a relatively long period of time—in comparison with the other methods discussed previously—to obtain the results. But the most important handicap to the development of the experimental method is the difficulty of setting up the proper controls.

The test situation in an experiment must reflect as nearly as possible the real situation in which the test results are to be applied. Thus test cities in a

[12] For a discussion of uses and problems, see William Applebaum and Richard F. Spears, "Controlled Experimentation in Marketing Research," *Journal of Marketing*, January 1950, pp. 505–17.

new product experiment must be typical of the markets found throughout the country. In a pricing experiment, the various groups of test stores must be comparable to one another and to all other stores in which the product is sold. As a matter of fact, finding and matching groups of test stores and control stores, or test cities and control cities for that matter, is very difficult. Some differences always exist. Moreover, it is important during the course of an experiment that all variables be kept constant other than the one being studied. This is very difficult to do. The results of a pricing experiment, for example, might be affected to such a degree by unanticipated changes in the prices of competitive products that no valid conclusions could be drawn. Although the controlled experiment is a more scientific approach to marketing research than either the survey or observational methods, there are problems of methodology which restrict its usefulness. More and more effort is being made, however, to solve these problems and to utilize this approach.

COMMUNICATING MARKET INFORMATION

In the previous discussion, three principal sources of market information have been indicated: information derived from the analysis of internal records, information obtained from external sources, and information collected through the specific market research efforts of a firm. It is evident that much of this information will be retained for the internal use of a specific business enterprise and will not be disseminated to other business firms or to the general public. For example, the facts uncovered through analysis of internal records are likely to be held in close confidence within the specific company in order to avoid revealing information that might aid competitors. In the same way, information derived through original research, often at considerable expense, presumably gives the firm possessing the data a competitive advantage. Accordingly, such information is not likely to be widely disseminated to competitors, although it may upon occasion be made available to customers or potential customers.

For many types of market information, however, a definite problem of communication exists. This is particularly true of information collected and dispersed by governmental agencies and the other external sources mentioned in the preceding section. The information is made available, of course, in published form by means of government bulletins and reports, through trade journals and other business periodicals, and in other ways. But many businessmen, especially small businessmen, do not necessarily even know of the existence of these reports, and many of them do not subscribe to trade journals and other business papers. Moreover, the sheer volume of publica-

tions—in the United States there are more than 2,000 trade and business papers alone—which might contain valuable information is so great that it is virtually impossible to obtain and assimilate them all. Thus even large companies which maintain their own library facilities must decide upon the publications that will be of most value over a period of time and to a considerable extent limit their efforts to the collection of these items.

Most trade papers, of course, give news or review coverage to governmental and other publications of particular interest to their readers. This gives the readers an opportunity to keep abreast of current reports containing pertinent information. In addition, the Field Offices of the United States Department of Commerce keep on file many governmental and private reports and are able to assist businessmen in locating information on specific topics. There are, however, only 33 such offices in the United States, and many businessmen undoubtedly are not even aware of their existence or of the services that are available through them. Finally, some chambers of commerce attempt to collect various published reports and to assist their members in locating specific bits of market information. This can be, and often is, a valuable service to members, but the resources of the average chamber are limited and the service rendered can hardly be a complete one. Thus, although a great deal of effort is devoted to the dissemination and communication of market information, such information does not always reach the person who could use it and for whom it is intended.

Another and somewhat different type of communication problem is involved in the dissemination of current market news regarding prices, changes in market conditions, crop reports, and the like. Here speed of communication is of utmost importance, since those who first obtain knowledge of significant information gain a substantial trading advantage. Modern-day communication facilities, of course, place great emphasis on rapidity of transmission, and market news can be disseminated very quickly by means of teletype, telegraph, telephone, and radio. Nevertheless, the speed with which the knowledge of market conditions reaches interested persons varies greatly. Large business concerns, especially those operating in highly speculative markets and those in the perishable food industries, develop elaborate facilities for gathering market news, as, for example, leased telegraph wires or direct teletype service. But most smaller operators are dependent upon the periodic, and sometimes less complete, reports of newspapers and commercial radio stations.

In view of the competitive advantage to be derived from an early knowledge of certain types of market information released by the federal government, great care must be taken to insure that everyone has equal access to

the reports. For example, the Crop Reporting Board of the United States Department of Agriculture, when making its official estimates, meets behind locked doors and sealed windows in carefully guarded rooms. No one can enter or leave these rooms while the Board is in session. The final reports are released in accordance with strict security regulations, at a time scheduled as much as a year in advance, and in such a way as to prevent any possible information leak. When finally released, the information is communicated rapidly and widely through wire services, radio and television stations, and the press.

INTERPRETING MARKET INFORMATION

The final test of the value of market information is found in its use as a basis for making business decisions. And correct business decisions can be made only after proper interpretation of the available information. Regardless of how much information has been collected, it is valueless until interpreted, and the skill with which it is interpreted determines in large degree the success of many business enterprises. Moreover, the information must be interpreted in the light of the conditions and problems facing the particular enterprise. Thus two competitive firms may logically arrive at different decisions even though both have access to the same information.

Before market information can be interpreted, however, there must be some evaluation of its accuracy. Evaluation of accuracy is actually the first step in interpretation, since few people desire to base decisions upon inaccurate information. Market data are collected by many agencies and are derived from many sources. There are numerous elements of potential bias which may consciously or unconsciously affect the results. Some of these elements of bias have been previously discussed, especially as they affect the validity of surveys.

In evaluating the accuracy of market information then, especially information which has been collected by outside agencies, it is necessary to ask a number of questions. Who is the collecting agency and what type of reputation does it have for accuracy? What specific interest did it have in collecting this information which might lead to biased results? Does the report indicate the research methodology used to collect the information? If so, were valid and reliable methods used that are in accord with current approved research procedures? Finally, are the results believable? An example, only one of a number that could be cited, will illustrate the problem.

An independent radio station located in a large metropolitan area conducted a survey of radio listening habits at a time when television was first

beginning to make its appearance. The results indicated that the station had a substantially greater listening audience than any other station in the city, including the four network affiliated stations. This information was circulated to potential advertisers with the clear implication that their advertising should be placed with this station. How valid were the results of the survey? In the first place, the results were not too believable since at the time network affiliated stations were generally listened to much more than were independent stations. Secondly, the station itself conducted the survey rather than employing a reliable market research firm. Third, the research procedures were conducted in a very unscientific way. No systematic sample was drawn; in fact, the questionnaire was distributed through an advertisement in a newspaper which happened also to own the radio station. It was impossible to determine the characteristics of the sample, except that it was limited to the readers of the particular newspaper and more specifically to those readers sufficiently interested in radio listening surveys to clip the questionnaire, fill it in, and mail it to the designated address. Obviously, the result could hardly be regarded as an accurate bit of market information on which to base a management decision.

In addition to evaluating accuracy, the interpreter of market information must sometimes evaluate its comparability. It is often desirable to compare current data with data collected in previous years in order to establish market trends. But the question arises of whether the various sets of data were collected and compiled in such a way that they are capable of being compared. A good example is the Census of Business. Changes in classification are often made from one census year to another which make it difficult to compare the data for the various years.

A specific illustration, which was discussed in detail in Chapter 10, is the definition of a department store. Because of the changing criteria used and because of improved reporting procedures, the census reports show significantly fewer department stores in 1958 than in 1929 or 1939 and a declining ratio of department store sales to total retail sales. The extent to which these changes are really changes in the relative importance of department stores in the retailing structure and the extent to which they are merely changes in classification and definition cannot be readily ascertained. But many people have interpreted the data literally as an accurate reflection of the declining importance of the department store without making allowances for the lack of comparability.

Having established the accuracy and comparability of market information, the user is ready for the final interpretation of the data in relation to a specific business problem. Accurate interpretation is largely a matter of

logical analysis and the use of good judgment. But the interpretation of market information is hardly an exact science. Two grain dealers analyzing the same crop report may arrive at opposite conclusions with respect to decisions to buy and sell in the futures market. In certain cases, these opposite decisions may both be logical ones, since the two dealers may have different situations with respect to future needs and current stocks on hand. But in other instances, the differing actions are simply the result of different interpretations of the same information. One dealer will have made an accurate decision while the other will have made an inaccurate interpretation.

Another problem, and perhaps the most difficult of all, is the use of market information as a basis for forecasting. Market facts are essentially historical in character, a record of what has taken place in the past. But they must be used as a basis for management decisions that involve the future. Even the most carefully collected and interpreted market data may be inadequate for this purpose, in view of the fact that market conditions are continually changing. Nevertheless, the ability to take existing information and to use it accurately as a guide for future operations is a distinguishing feature of superior management. Thus it is important to realize the close relationship that exists between carefully interpreted market information and business success. In the modern market, such success depends in large degree on the ability of the individual business executive to use available market information in the wise formulation of business plans and policies, both for present and future operations.

QUESTIONS FOR DISCUSSION

1. In a mail questionnaire survey conducted by a radio station, one of the questions asked was, "At what times would you like to listen to news broadcasts?" Evaluate this question and suggest alternative questions that would be more suitable.
2. A newspaper making a brand preference study with respect to a number of food, drug, and household items published the questionnaire in one of its issues and offered a small prize to those who would fill it out and return it in person to the newspaper office. Assuming that the purpose of the study is to determine the brand preferences of the residents of the city in which the newspaper is published, what deficiencies of sample design can you point out?

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25. STANDARDIZATION

Some of the most important problems involved in marketing are concerned with the function of standardization—that is, with the division of commodities into groups that have important characteristics in common. Standards have long been established for monetary units and for weights and measures, and through the years a growing realization of their importance has resulted in the establishment of a wide range of other standards. So important have standards become that it would be exceedingly difficult to carry on business operations without them. Nevertheless, there is often resistance to the establishment of quality standards and to the dissemination of information about product grades. The result is that purchase decisions, especially by the ultimate consumer, are often made without a very exact knowledge of the quality of product being obtained, and marketing is carried on at a greater cost and with a lower degree of efficiency than might otherwise be attained.

BASIC CONSIDERATIONS

The Elements of Standardization

The marketing function of standardization includes (1) standardizing, or the determination of the standards to be established, (2) grading, or the dividing of goods into lots according to the standards previously established, (3) the inspection of commodities for grade or quality determination, and (4) labeling the product or container in such a way that the grade or quality is evident without further examination.

Standardizing. To standardize is to determine basic limits to classes of products. Thus for most types of wheat the standard for Grade No. 1 requires a minimum test weight of 60 pounds per bushel, the standard for No. 2 is

58 pounds, for No. 3 it is 56 pounds, and so forth. In addition, maximum limits are set for damaged kernels, foreign material, and wheats of other types, these limits being greater for the lower grades.[1] Standards are available for most canned fruits and vegetables according to a numerical rating of 90 points minimum (out of a possible 100) for Grade A, 75 to 89 for Grade B, and 60 to 74 for Grade C. Points are allotted for various characteristics, such as color, uniformity of size, and absence of defects.[2]

Standards established in these and other ways serve as specifications for manufactured products and determine the classes or grades into which the products of agriculture and the extractive industries are divided. Standards generally serve as a basis for future use, and to be effective, they must be relatively permanent (and must be used by a considerable proportion of sellers and buyers). They give permanence to grades so that specifications can be used in various markets and from year to year. Established standards are commonly called "grades."

Grading and Inspection. To grade is to divide goods into lots which have approximately the same characteristics as to type, size, or quality—that is, to sort products into the standard grades to which they belong. Grading must necessarily be accompanied by some form of inspection or testing in order to determine the characteristics of the goods. For some products, such as oranges and apples, the individual items are inspected and sorted into lots that conform to the established standards. With other products, a given lot is inspected to determine the standard to which it conforms. This is commonly carried out by examining samples which are assumed to be typical of the entire lot. Wheat and the other grains, cotton, and butter are examples of products graded in this manner.

In the case of manufactured goods, it is usually possible to establish a standard of quality and to produce to this standard. Inspection of the finished product is often necessary to be certain that each item conforms to the standard. Statistical sampling techniques have been developed whereby only a sample of finished products is inspected. Properly used, these methods assure adequate quality control without incurring the expense of inspecting each item. In any event, the emphasis with respect to the standardization of manufactured goods is usually placed on inspection rather than on grading.

Labeling. After standards and grades have been determined, it is necessary that some means of grade identification be devised and used so that buyers will know the grade of the product being purchased. In transactions between

[1] See *Official Grain Standards of the United States* (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, 1960).

[2] For a more complete explanation, see Jessie V. Coles, *Standards and Labels for Consumers' Goods* (New York: Ronald, 1949), pp. 417–8.

business firms there is little problem. The purchase and sale contract or purchase order may well specify the grade to be delivered. Sellers usually designate the grade on the invoice and other documents of sale. Warehouse receipts specify the grade of the products held in storage. Thus it is not necessary, and in fact it is often physically impossible, to label the product with its grade designation.

With consumer goods, however, labeling is an important problem. Documents of purchase and sale are not customarily used; if they are used, grade specifications are unlikely to be recorded. Normally the only way the ultimate consumer can be aware of the grade of a specific product is for it to be affixed on the label or package. Most consumer products do not carry such information on their labels, even though in many instances they do conform to recognized standards. For example, canned fruits and vegetables are usually graded according to the trade designations of Fancy, Choice or Extra Standard, and Standard. These correspond generally to the consumer grades of A, B, and C. It is customary in transactions between the canners and wholesalers and retailers to specify the grade of product being purchased and sold. Complete information is likely to be available to the buyer through the invoice and other documents. But most such products are not labeled as to grade, and the ultimate consumer does not know the grade of the item purchased. Thus a common standardized nomenclature is used to facilitate business transactions but such information is withheld from the ultimate consumer, thereby rendering his buying efforts somewhat less effective than they might be otherwise.

The Significance of Standardization

Sales are made by inspection or by sample or by description. These are the fundamental bases of exchange. Unstandardized products must be sold by inspection, which greatly impedes the efficiency with which the exchange of goods is accomplished. Products which are standardized with respect to the characteristics considered important by the buyer can be sold by sample or description, and thus on the basis of a grade or symbol. Purchase and sale are thereby greatly simplified. For when the quantity, size, and quality of a lot of goods are known, price and terms of sale are the only undetermined factors essential to the consummation of the transaction. The creation of a favorable buyer attitude toward a product, or toward the firm that produces it or the middleman who sells it, is also facilitated when carefully graded products are sold. And marks of identification—trade-marks, brand names, or other symbols—when attached to a standardized product, enable the satisfied consumer to buy the same product again and again. Or, if the

products are unsatisfactory, these same marks make it easy to avoid purchasing them in the future.

Standardization is essential to the use of mass methods of selling. Advertising, for example, in most of its manifestations is dependent upon mass appeals. Mass methods are likewise characteristic of the modern use of salesmen by large organizations. Advertising and personal selling involve large costs, which are economically justified only by the sale of a large volume of similar products. This is especially true when the value of the sales unit is small. To put it in another way, modern large-scale methods of selling, whether based on advertising or the use of salesmen, are too expensive to use unless they can be employed to sell standardized products in large volume. Standardization of products, consequently, is fundamental to the success of the sales efforts of most large manufacturers, as well as of those large cooperative enterprises which use advertising and salesmen in creating demand for agricultural commodities.

Standardized products are easily evaluated, and thus the collection of claims against railroads and warehouses for loss or damage is facilitated. Hedging and futures trading are dependent on standard grades. When commodities are standardized, market news of supply, demand, and price reaches a maximum of accuracy and hence of value. Price quotations serve best in conveying values to buyers and in facilitating the close comparison of values when they apply to commodities that are divided into narrow, uniform lots. This is true because the quotations then apply to goods with definite qualities. Methods of financing are simplified and loans on commodities in storage and in transit are more readily arranged because uniform lots are easily evaluated, because price fluctuations are more certainly followed and more quickly detected, and because warehouse receipts representing graded commodities constitute good collateral for loans. Because of the same considerations, risk is reduced. The exact grade and quantity of a commodity can be shipped to a given market or buyer, and so economies in transportation and storage result. Lots bought at different times or from different producers may be mixed together, if all essential characteristics are the same.

Standards and the Buyer. Standards are presumably set to accord with the needs of buyers. This is especially true of industrial goods and raw materials. Manufacturers prefer to purchase standardized commodities. They commonly sell a standardized product, which is frequently identified by brand or trade-mark, and which can be most easily and economically produced from standardized raw materials. Moreover, the purchase of ungraded materials causes extra expense in buying, since such products must be inspected and sorted and the surplus of unused products must be sold.

It must not be assumed, however, that all standards conform to the demands of buyers. Many standards are determined on the basis of technical criteria which are easily applied and which it is assumed will be considered important by purchasers. It is, in fact, extremely difficult to ascertain the desires of buyers and particularly the preferences of final consumers whose desires are in large part subjective, are frequently unformulated and unexpressed, and change from time to time. Hence it is difficult to agree upon standards which will best satisfy buyers and so result in the largest net returns to sellers. Studies of consumer preferences by manufacturers and other interested agencies are throwing light on this phase of standardization and are bringing about improvements by influencing the standards used and the qualities produced.

Bases for Standards

Standards rest upon various bases. The most common bases used are quantity, size and measurement, quality, and color. Most standards rest upon more than one basis. For example, grain standards, as previously indicated, are based on both weight and quality. Color is important in the grading of raw cotton and certain fruits, but it is considered essentially as a criterion of maturity and quality in general. Standards of quantity, size, and quality are all of considerable importance in marketing.

Quantity Standards. Since many products are sold by quantity or by weight, the standardization of weights and measures is fundamental to the smooth operation of a marketing system. Weights and measures are so important that states, municipalities, and the federal government all exercise an influence in their regulation. The state and federal governments prescribe standards and provide machinery for enforcing them.[3] Many cities have officials whose duty it is to inspect retail weights and measures.

Steps have also been taken by the state and federal governments to protect purchasers by developing and insisting on the use of standardized containers and packages. The United States Department of Agriculture, as a result of authority given by various federal laws, has developed and enforced the use of standard measures for handling agricultural products in interstate commerce. Thus, under authority granted by the Standard Container Act

[3] For a brief history of federal legislation regarding weights and measures, see Ralph W. Smith, *The Federal Basis for Weights and Measures*, Circular 593 (Washington, D.C.: National Bureau of Standards, U.S. Department of Commerce, 1958). See also E. C. Crittenden in *Marketing: The Yearbook of Agriculture, 1954* (Washington, D.C.: U.S. Department of Agriculture, 1954), pp. 143–50.

in 1916, the Department reduced substantially the number of sizes of boxes and baskets previously used in the marketing of certain fresh fruits and vegetables. A second Standard Container Act, passed in 1928, carried federal standardization of containers still further and established the standard bushel of 2,150.42 cubic inches. The Standard Barrel Act, passed by the federal government in 1915, is enforced by the National Bureau of Standards of the Department of Commerce. The federal Food, Drug and Cosmetic Act requires that quantities shall be plainly marked on packages of food and drugs entering interstate commerce. Most of the states have similar acts, many of which are based on federal standards.

Standards of Size and Measurement. Size standards are very important also. Bolts and nuts, screws, pipes and fittings are examples of products that require a large degree of standardization in order to avoid marketing chaos. Lumber is another product which is commonly sold in standard sizes, and window glass for homes can be obtained more economically if the windows are cut to standard sizes. In recent years, much progress has been made in complete standardization of the dimensions of the entire house, which has permitted prefabrication of the various parts, a minimum of custom building, and a lower cost.

Size standards are of considerable importance also in clothing and shoes, but much remains to be done if standardization of these products is to be achieved. Almost everyone has had the experience of purchasing the customary size of an article of clothing, only to obtain a poor fit. In 1955 the United States Department of Commerce established and published recommended size standards for women's ready-to-wear and urged their adoption by the industry.[4] Mail order houses, for obvious reasons, were most active in requesting the Department of Commerce to establish these standards, and they along with other large retailers, such as the J. C. Penney Co., were the first to adopt them. Independent designers and manufacturers have been somewhat slower to establish uniformity, but in 1958 the knitted outerwear industry accepted the standards. Most dress manufacturers have not adopted the new standards, partly because of the expense involved but mainly because they fear the result would be a lack of individuality in design.

Quality Standards. The standardization of quality is often very difficult. This is particularly true in the case of consumer goods, since individual consumers differ greatly in the manner in which the attributes of products appeal to them. Different consumers will always react differently to certain charac-

[4] See *Business Week,* January 8, 1955, pp. 62 ff. The standards are set forth in a booklet, *Recommended Commercial Standard on Body Measurements for the Sizing of Women's Patterns and Apparel.*

teristics of products, even though the products are standardized, and a particular consumer's evaluation of these characteristics will frequently change with the passage of time. This fact renders possible much of the competitive selling of goods—the pitting, for example, of one brand of soap against the rest of the field. Since the consumer does not know just what qualities and attributes of many products are most important or which appeal most to him, and since different consumers are differently affected, vendors find it is advisable to differentiate their products from competing goods. If the differentiated product appeals to buyers, demand can be created for it. Then, with the product differentiated and standardized, the demand thus created can be satisfied only by the purchase of this particular product. Because of the difficulty of establishing quality standards and because of the desire of many manufacturers of consumer goods to achieve product differentiation, quality standardization is a most controversial topic. For this reason, much of the ensuing discussion will be concerned with it.

Need for Standardization in Marketing

The degree to which standardization needs to be carried on as a marketing activity depends on the extent to which products are standardized in the process of production. When products are not of uniform variety, size, and quality when production is completed, they must be sorted to conform to such standards as are to be used in marketing them. Many agricultural products fall in this class. Manufactured goods, on the other hand, which are produced in large volume at a time by a single manufacturer are usually of uniform size, shape, and quality.

The greater the number of important characteristics that can be recognized in a standard the more valuable it is. But all characteristics need not be recognized to make standardization helpful to marketing. If characteristics cannot be quickly and inexpensively determined, the grading process may take too long or be too costly. The protein content of wheat, for example, is recognized to be of great importance, but federal grades do not measure it directly. Size and length of steel bolts with a standard number of threads per inch make it easier for the average consumer to buy bolts, even though he does not know the exact quality of the steel. Again, most products are officially graded by sample, and the degree to which the sample is like the bulk depends in part on conditions of production, in part on careful sorting. Finally, errors in judgment are sometimes made, especially since the testing methods used are themselves variable and certainly not infallible. Obviously, the human

element is an important and necessarily variable factor.[5] But with all the weak elements in our system of standardizing and grading, the fact that certain characteristics can be recognized with reasonable accuracy greatly facilitates the marketing process.

THE STANDARDIZATION OF AGRICULTURAL PRODUCTS

Need and Problems Involved

The standardization of agricultural products is typically performed during the marketing process. Because of the difficulties involved in controlling the quality of the product during the production process, standardizing and grading are essential for efficient marketing. Moreover, the problems involved in the standardization of agricultural products differ greatly from those faced by the buyers and sellers of manufactured goods.

Most agricultural products are unstandardized as they come from the farm, and the products of different farms also differ in variety, quality, and size. In order to obtain the benefits of standardization, standards have to be established and the goods sorted into lots which conform to these standards. Eggs, fruits, vegetables, and wool, for example, are standardized in this way. The grains, however, are not conveniently sorted so as to conform to the specific grades. But since the grain from a single grower or even a particular territory tends to be uniform, sorting is not essential. Quantities in bulk are sampled, and by inspecting the sample the grade of the bulk is determined according to the standard to which it conforms.[6]

The perishability of many agricultural products is also a factor that complicates the performance of the standardization function. It is easier to grade commodities that are not perishable since they need not be hurried to market in order to avoid deterioration. Moreover, when determined, the grade applies for a considerable period of time. When haste is essential, standards must be quickly applied and grading is less carefully carried on. It is for this reason that the development of refrigeration has aided so materially in the standardization and grading of perishable farm products.

[5] The constantly increasing use of mechanical grading devices serves, of course, to reduce the element of human error. A case in point is the recent development of an electronic machine to measure the staple length of cotton. This was previously done by visual inspection. The machine is both more accurate and faster. See *Business Week*, February 27, 1960, p. 61.

[6] For a description of the way in which a sample of grain is taken, see *Grain Grading Primer*, Misc. Pub. No. 740 (Washington, D.C.: U.S. Department of Agriculture, 1957), pp. 6–7.

Deterioration is inevitable with the more perishable products, and in the federal inspection of fresh fruits and vegetables both the quality and condition are considered. "Condition" refers to any change in quality or size which may occur after the product has been packed. A major difficulty in using grades for highly perishable commodities arises from the fact that quality may not carry through from point to point in the marketing process. A product may meet the requirements of a certain grade when inspected at the shipping point, but it may be below them when it arrives in receiving markets or retail stores. Some items may have decayed, become bruised, or shrunk in size during transportation and handling. Consequently, dealers need to know the condition as well as the quality of the commodity they are handling.

Extent of Standardization

Provision for the standardization of agricultural products is usually made through federal laws, state laws, or both. Most laws are permissive rather than mandatory. That is, they provide for the establishment of standards, and in many cases for governmental inspection of the products, but they do not require that the products be graded and sold in accordance with the standards set forth. Some laws, however, are mandatory or virtually so. For example, the federal Grain Standards Act of 1916 provides for the establishment of grain standards and for the licensing and supervision of grain inspectors. All grain shipped in interstate or foreign commerce which is sold by grade must be inspected and graded by licensed graders. Thus technically, mandatory federal grading does not seem to be required, but actually all grain sold through normal commercial channels is federally inspected and graded since it is sold by grade and no other grading is permitted.

Federal standards of quality have been established under various laws for more than 300 commodities including all of the grains, cotton and wool, fresh and processed fruits and vegetables, dairy products, poultry and eggs, livestock and meat (including even rabbits), tobacco, and naval stores.[7] This work of standardization is carried on by seven commodity divisions[8] of the Agricultural Marketing Service of the United States Department of Agriculture. This agency develops the standards in cooperation with businessmen and state agencies. It supervises inspection, often in cooperation with state

[7] For a listing of all products and grade names, see *Grade Names Used in U.S. Standards for Farm Products*, Agriculture Handbook No. 157 (Washington, D.C.: Agricultural Marketing Service, U.S. Department of Agriculture, 1958).

[8] These are as follows: Cotton, Dairy, Fruit and Vegetable, Grain, Livestock, Poultry, and Tobacco.

agencies, and issues, when they are required, certificates of grade. As previously indicated, the use of these standards is largely permissive but many of them are widely used in wholesale transactions, and some—those for meat, eggs, and butter, for example—are often carried through on products sold in retail stores.

The several states have also established standards and grades for a number of agricultural products. Some states require certain of their own products, i.e., those produced in the state, to be graded according to the state standards, and some require certain products shipped from other states to be so graded. Some of these grades are based on federal standards, but a larger number are not and they also differ from other state standards. Obviously, conflicting standards of this kind are confusing and interfere with the free flow of commerce among the states. Whether there is justification for these conflicting standards is difficult to say. In some instances, especially for products which are of great importance to the economy of a given state, it is alleged that the federal standards are not sufficiently exacting or descriptive to distinguish accurately the various qualities of product that may be available. In other cases, it may well be that the differing state standards are designed to protect local products from those grown in other states. In any event, it would be desirable if this type of confusion could be removed by the development of federal standards which meet the real needs of all of the states and by the adoption of such standards on a universal basis.

Another unnecessary element of confusion lies in the wide variation of grade designations that are applied to products. This is especially true when the designations are used in sales to the ultimate consumer, who generally is not familiar with them. Many products are graded as No. 1, No. 2, or No. 3, or as Grade A, Grade B, or Grade C, and such designations are clear enough. But objections may be raised to the No. 3 or C grade by producers and others on the basis that it sounds too inferior. The solution often is to eliminate it—actually most fresh fruits and vegetables are classified into only two grades according to federal standards—or to revise the grading system so that the third grade will be less obvious. For example, the first three federal grades for fresh apples are extra fancy, fancy, and No. 1. Butter and eggs are graded AA, A, B, and C; celery and topped carrots are extra No. 1, No. 1, and No. 2; certain table grapes are fancy, extra No. 1, and No. 1 although other grapes are No. 1 and No. 2.

Beef carries the designations prime, choice, good, standard, commercial, utility, cutter, and canner, although consumer grade designations are sometimes more simplified, while veal omits the commercial grade and substitutes cull for cutter and canner. One type of cotton with ten grades carries straight-

forward designations ranging from No. 1 to No. 10, but another with eleven grades uses half numbers and the lowest grade is No. 6—not to mention the various other types of cotton which use name designations rather than numbers. No doubt the alert student has arrived at the conclusion by this time that his own grading problem in college courses might be easily solved, especially the explanations to parents, by merely revising the existing A, B, C, D, F system to AAA, AA, A, B, and C. In any event, it would seem that the commodity grading system could be more simple and more intelligible, although it is perhaps of little importance in wholesale transactions involving informed buyers. The complexity of grade designations, however, is one reason why more grade information is not made available to consumers.

THE STANDARDIZATION OF MANUFACTURED PRODUCTS

Emphasis on Individual Standards

The quality of manufactured products can be more closely controlled during the production process than can the quality of agricultural products. The first problem of the manufacturer with respect to standardization, therefore, is to determine the standard of quality that he desires to obtain in the finished product. He then purchases the quality of raw materials and establishes the controls over the production process necessary to achieve this standard. With manufactured goods, therefore, there is less emphasis on trade or industry standards and more emphasis on the individual standards established by producers or buyers than is true for agricultural products. Moreover, the problem of mixing similar products from a number of producers, which is important with farm products, arises only to a limited extent.[9] Accordingly, the marketing function of grading is largely eliminated, the emphasis being placed on inspection of the goods during the production process.

Another reason for the lack of industry standards, especially in the case of manufactured consumer goods, is the emphasis of producers on product differentiation. Each manufacturer, in his effort to satisfy the varying wants and desires of consumers and to obtain a competitive advantage, attempts to develop and produce a product somewhat different from those being produced and sold by his competitors. The differential advantages of each product, rather than its standardized characteristics, are emphasized and promoted through advertising, personal selling, and brand identification.

[9] As, for example, in the buying of fabricated parts by manufacturers or private brands of merchandise by large retailers.

Thus individual standards are of the greatest importance in the marketing of manufactured products. Such standards may or may not conform in part with generally recognized standards promulgated by governmental or trade organizations. They may or may not be known and understood by purchasers. They may or may not be standards which can be definitely tested by purchasers. But even though the standards are not known by the purchaser or cannot be tested by him, they may nevertheless be of value. For if the purchaser likes a given product and has faith that other products from the same source will be similar, it is easy for him to make repeat purchases. Moreover, the selling function is performed more easily by the producer and the middlemen who market his product by virtue of the individual standard that has been established.

The use of individual standards, however, may not be a completely satisfactory solution to the buyer. The claims and counterclaims of sellers with respect to the quality of their respective products may be confusing. The inspection procedures used by manufacturers may not disclose all defective items. Moreover, close standardization is not always possible and may be too expensive to achieve. Accordingly, buyers may find it necessary to inspect with care the products they purchase. This, however, is often impossible both because of the lack of knowledge of the consumer and because of the inaccessibility of the product as a result of packaging and other factors.

The type of standardization that is most important to the buyer and to marketing, as has already been indicated, is to be found in the establishment of standard specifications based on the important characteristics of the product and in the controlling and publicizing of these standards so that the buyer knows their meaning and has confidence that the products conform to them. It is because of the common absence of these two criteria of usable standards in the marketing of manufactured consumer goods that so much emphasis has been placed on the development and publicizing of usable standards by many persons and organizations interested in marketing from the consumer point of view.

The Development of Industry Standards

Industry standards have been developed for many manufactured products, especially for industrial goods. A large number of engineering societies, trade associations, and governmental agencies have interested themselves in the establishment of such standards. One of the most important of these is the American Society for Testing Materials. This is a technical association engaged in promoting knowledge of engineering materials and the standardiza-

tion of specifications and methods of testing.[10] Another important organization working in the field is the American Standards Association. This association is a federation made up of trade and technical associations, major branches of the federal government, and a large number of individual companies. Its function is to serve as a clearinghouse through which industrial and technical groups and governmental agencies develop and coordinate standardization programs.

Both the American Standards Association and the American Society for Testing Materials operate by bringing together representatives of all parties who have an interest in the development of particular standards. The procedure of the American Standards Association, for example, is to investigate a specific problem only after a request has been received by an interested group for the establishment of a standard in some specific field. After in-investigation of the work that has already been done, a general conference is called to which are invited representatives of all groups thought to be interested in the subject. This conference decides whether the establishment of a standard shall be undertaken and, if so, how the work is to proceed and who shall undertake the primary responsibility.[11] As a result of this type of effort, hundreds of industry standards have been established for products ranging from bolts and nuts, iron and steel products, and electrical equipment to gas appliances and safety glass.

Both associations are now working on definite programs for the development of standards for ultimate consumer goods, although progress is undoubtedly slower in this field than in the case of industrial goods. Nevertheless, many standards already established benefit consumers as a result of their wide acceptance by manufacturers and their use by wholesale and retail buyers. In this work, both organizations have established consumer goods committees and have added consumer representatives to their usual technical committees.[12]

One of the most important agencies engaged in developing standards for manufactured products is the National Bureau of Standards of the United States Department of Commerce. For many years the Bureau has cooperated

[10] See Paul S. Olmstead, "Quality and the Consumer," in *Quality Control and The Consumer*, Conference in the Interest of Consumer Education, September 1957, Rutgers University, pp. 38–40.

[11] See G. F. Hussey, Jr., "American Standards and the Consumer," in *Quality Control and The Consumer*, *op.cit.*, pp. 9–11.

[12] Both organizations indicate that it is difficult—obviously—to obtain consumer representatives who can speak with authority as to what consumers want. Accordingly, most of the so-called consumer representatives consist of retailers, professional home economists, and representatives of consumer agencies of the federal government. See Hussey, *op.cit.*, p. 10.

with industrial groups in their efforts to reduce the types and sizes of products, and it is constantly working on the development of standards under its own projects and in cooperation with trade and technical associations. Aside from its important work as the principal testing laboratory for supplies purchased by federal agencies, it conducts many of the investigations leading to the establishment of the specifications used in purchasing those supplies, and it serves to coordinate the work of the various federal agencies engaged in developing and using such specifications. It cooperates with national and international scientific, technical, and trade associations engaged in the development of standards and related efforts and takes an important part in the work of the American Standards Association and its affiliated organizations. It also assists with the adoption of standards for weights and measures and makes many tests for state and federal agencies.

THE CONSUMER AND STANDARDS

Nature of the Problem

Despite the efforts of the agencies mentioned above, the standardization of manufactured products is in large degree undertaken by individual manufacturers and does not necessarily conform to generally accepted trade or governmental standards. This is particularly true of consumer goods. Thus the basis on which the standards of many manufacturers rest is unknown to the final consumer, a situation which makes its difficult for him to compare competing products. Where trade or governmental standards prevail, they are generally unknown to the majority of consumers and are not understood by a large proportion of those who know of their existence. Moreover, many sellers make claims about the quality of their products and concerning their values in use which the buyer has no way of checking and which are sometimes misleading or even false. Even the federal and state standards for agricultural products, which are widely used in wholesale marketing, usually do not carry through to the consumer. This absence of helpful industry-wide standards is rather widely recognized as a handicap to effective consumer purchasing. The attempts to have such standards established on a basis that will assist consumers in buying more intelligently and to educate consumers in their use are among the main objectives of some consumer organizations.

The objectives of those who seek the establishment of useful standards for consumer goods are: (1) to develop standards that will enable the consumer to determine the quality of commodities and so make it possible for

him to compare competing products, (2) to have products so labeled that the consumer can tell at the point of purchase what qualities inhere in them, (3) to have these operations carried out in a manner that gives the consumer confidence in the standards and labels, and (4) to educate the consumer so that he will understand the importance of the standards and be able to understand the methods by which they are designated on the product or its container. Closely related to these points is the consumer's desire that those who sell products, whether or not they conform to acknowledged standards, shall see to it that truthful and useful information is given through advertising and personal selling.

These objectives are difficult to attain. In the first place, although there can be no valid argument against the right of the consumer to know the quality of the product he is buying, how it operates, and how to use it to the best advantage, there is no particular unanimity of opinion as to just what this involves or how it can be brought about. In the second place, the development of useful standards and of devices making them intelligible to consumers is often very difficult. And finally, the attainment of these objectives requires the cooperation of large numbers of people with diverse interests. Sellers must be convinced not only that it is to their own interest to have informed consumers and that consumers want to be informed, but that specific plans for carrying out the objectives are possible and practical. The cooperation of trade associations and governmental agencies is often necessary. And consumers must be made to realize that the establishment of standards is important to them. They must make their desires known, study established standards, and give evidence that they can and do use them. Although it is important and often difficult to overcome the opposition, inertia, or hesitancy of sellers, it appears that the problems involved in developing useful standards, carrying them through to consumers, and educating consumers to their use are the more difficult barriers to success.

The types of issues involved may be illustrated by the controversy concerning the establishment of standards for canned fruits and vegetables and the way in which information as to quality is carried through to the consumer. Standards have been established by the United States Department of Agriculture and continuous factory inspection service is available to canners who desire to label their products as U.S. Grade A, U.S. Grade B, or U.S. Grade C. If the continuous factory inspection service is not utilized, the canner may provide his own inspection facilities and still label the products as Grade A, Grade B, or Grade C without the U.S. prefix.[18] But most canners

[18] If the grade designations established through private inspection are inaccurate, the canner may be subject to prosecution under the mislabeling provisions of the Food, Drug and Cosmetic Act.

do not label their products as to grade. They maintain that the grades are not understood by consumers and that they are not sufficiently informative with respect to particular characteristics of the product. This has led to considerable controversy over what characteristics of products should be measured and whether descriptive labeling or grade labeling is preferable.

Those who favor descriptive labeling point out that important characteristics cannot be measured objectively, and hence must be described. In this way, it is argued that the buyer will have a better understanding of what the label means and can place his own evaluation on the importance of each characteristic; whereas under grade labeling he is likely to be ignorant of what characteristics are considered and of the weight given to each. It is further pointed out that under grade labeling not only is the measurement of certain characteristics dependent on the judgment of the grader, but also that the weight given to each is of necessity quite arbitrarily determined. Those who favor grade labeling point out that grades are easier to use than descriptive labels, that consumers can and will learn what they mean, and that they have been used with a considerable degree of success in the wholesale trade for years. It is assumed that, if grades assist wholesale buyers who are purchasing goods that will ultimately be purchased by consumers, they will also aid the consumer.[14]

Although much less public attention has been focused on this problem during the past decade than was once the case, the issues have not been resolved. Whether descriptive or grade labels are to be used, while important, is perhaps not the fundamental point. More important is the need to devise a means by which the labels used give information that is not only useful but sufficiently standardized throughout an industry so that comparisons can be made. Moreover, the labels must be controlled under a system that gives the consumer confidence in the honesty of the label by assuring him that the products have been inspected by an impartial agency. This seems to point to supervision and control by a federal governmental agency.

That federal and state governments must play an important part in devising standards and controlling labels for consumer goods seems obvious, but the efforts of businessmen and of consumers are equally important. Many manufacturers and retailers are now trying to describe products so consumers can learn what they need and wish to know. If consumers demand such information, other sellers will be forced in line. The greatest protection of the

[14] This is a very brief presentation of the argument. For further discussion of the pros and cons of grade labeling, see Jessie V. Coles and H. E. Erdman, "Some Aspects of the Arguments Against Grade Labeling," *Journal of Marketing*, January 1945, pp. 256–61; and G. B. Hotchkiss, "Some Fundamental Objections to Mandatory A B C Grades," *Journal of Marketing*, October 1945, pp. 128–34.

consumer is and must continue to be found in the integrity of the businessman with whom he deals. It is because consumers now believe in the basic integrity of the overwhelming majority of manufacturers and retailers that they are willing to purchase so many products by brand. If more usable standards are established and if these are supported by associated or governmental efforts, purchasing will be greatly facilitated. But even when standards are supported by the force of law, consumers and other buyers must still depend in large measure on the willingness of producers and middlemen to produce and sell in conformity with the established standards.

Progress in Standardization

Fundamental to the use of commodity standards is the standardization of weights, measures, and containers. With the exception of the containers in which commodities are packed, these basic standards are well established and their use is made compulsory by legal enactment.[15] Considerable progress has also been made toward the standardization of containers, and containers prescribed by federal agencies must be used in interstate trade in certain products. Many products, especially those falling under the federal Food, Drug and Cosmetic Act, cannot be sold in interstate commerce in "misleading" containers, and containers must bear an accurate statement of the quantity of the contents.

Considerable progress has been made in the development of uniform standards for some consumer goods. Wholesalers and retailers are not only purchasing with greater care, but many of the larger establishments operate or utilize the services of testing laboratories to guide their purchasing and to supply information about their products which can be carried through to consumers by means of descriptive labels, informative selling, and advertising. Others are making use of federal grades which can be carried through to the consumer, such as those applying to canned fruits and vegetables, butter, eggs, and meats. These efforts to give consumers adequate information are not widely undertaken, but they are being used in increasing degree and appear to mark a definite tendency.

State and federal agencies are also active. The Federal Trade Commission in particular, through its powers to control methods of unfair competition including advertising, has done much to assist in the development of standards and to protect consumers against false and misleading advertising and labeling. Trade practice conferences have been used extensively

[15] How well these laws are enforced is perhaps subject to debate and undoubtedly varies considerably from one state or locality to another.

by the Commission as a basis for the establishment of trade practice rules for many industries. In addition, the Commission's powers with respect to the regulation of the labeling of textile products is now quite substantial. The earlier laws requiring the labeling of wool products and fur products, the Wool Products Labeling Act of 1939 and the Fur Products Labeling Act of 1951, have been supplemented by the Textile Fiber Products Identification Act of 1958.[16] As a result of these laws, which require manufacturers and retailers to label by generic name the fiber content of most clothing and household textile items, the consumer is obtaining at least some of the information necessary to make comparisons among products. Obviously, the standardization of even these products is by no means complete but progress is being made.

CONCLUSIONS

Standard weights and measures eliminate the difficulties involved in knowing what quantities are exchanged. Buyer and seller can thus come to an immediate agreement on that score; and, in case of dispute, recourse can be had to an impartial judge for interpretation of the standard scale or standard measure. Quality is the unknown factor in most mercantile transactions. The extension of universally accepted standards of quality should go far to make marketing more efficient and less costly. Every advance which increases the ease with which buyers can determine quality speeds the marketing process and, as a rule, reduces its cost as well.

If standardization is to achieve the greatest results for effective and economical marketing, it is important that standards be used as near to the original source as possible and carried through the marketing channels to final purchasers. This can be done with weights and measures, and many commodities go to the final consumer in original containers. Quality standards can be carried through for manufactured goods and many minerals. Agricultural products more and more are graded and bought by grade at country points. These grades can be carried through to the wholesale market and to manufacturers, and grades for the less perishable products can be carried through to the retailer and even to the consumer. But in the case of perishable products, it is difficult and often impossible to carry the grades through to the final consumer.

The past efforts of consumers and consumer organizations have greatly increased the interest in consumer standards on the part of manufacturers, wholesalers, retailers, governmental agencies, and trade associations. These

[16] See Chap. 7 for further discussion.

efforts have been responsible in part for the development of an increasing number of consumer goods standards and their use by manufacturers and middlemen. Some progress has also been made in educating consumers in the use of these standards. Much remains to be done, however, in the standardization of consumer goods. The problem is a complex one and it will not be easily solved. No doubt gradual progress will continue to be made in its solution.

QUESTIONS FOR DISCUSSION

1. The article by James B. McNallen cited in the bibliography describes the change of policy made by the Sun Oil Company in 1956 from selling only one grade of gasoline to selling five grades of gasoline from the same pump. By means of a selector switch, the gasoline is blended automatically according to the grade selected by the motorist. The grades were designated as 200, 210, 220, 230, and 250. The 200 grade is stated to be equal in quality to the previous single grade and was sold at the same price. A price increment of one cent per gallon for each higher grade was established except that the increment was two cents for the top grade. The advertised advantage of the new system was that the consumer could select the *right blend* for his car.

   Evaluate the policy from the standpoint of the consumer and the company. Does this action lead to greater standardization or to greater product differentiation? Evaluate the grade designations adopted from the standpoint of the company and the consumer.
2. The Wool Products Labeling Act of 1939, which required the labeling of products as to the percentage of wool fiber content and whether the fiber consisted of pure virgin wool or reused wool, was presumably designed as a measure of consumer protection. Despite the efforts of consumer organizations for many years to obtain such a law, it was not enacted by Congress until strong pressure was brought by the wool growers' association. This served to counteract effectively the opposition of manufacturers. Likewise, Rhodes points out in the article cited below that the marking of beef grades was achieved by producer interests, over the protests of packers, rather than by consumer interests.

   How do you explain the apparently conflicting interests of the original producers and the processors? Are these interests really in conflict? Why are producers able to exert more influence on government than do consumers?

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PART VI

PRICES, PRICE POLICIES, AND GOVERNMENT IN MARKETING

26. COMPETITION AND PRICES

THE SIGNIFICANCE AND MEANING OF PRICE

Price is a matter of fundamental interest to both buyers and sellers in the market. Buyers and sellers alike at all stages from production through the marketing process to the final consumer must constantly watch prices. For the producer, such as a manufacturer, mine operator, or farmer, the price at which he sells may have varying effects on his ultimate net profit. For example, price helps to determine the volume of his sales and may also affect his unit costs if his expenses vary with the volume of sales or with the scale of production. For the merchant the difference, if any, between cost and selling price determines the margin on which he must operate in any given transaction and the markets in which he can buy and sell. While the consumer is interested in improvements in service and quality of product, at any given time the relative price of similar products is his major interest.

Moreover the price of one seller is the cost of another. Both producer and middleman are interested in prices, not only as determining their volume of sales and margins of profit, but also because they determine the expense of doing business as shown in the price of raw materials, machinery, labor, funds, land, and services—the costs which must be met if the business is to continue.

The price of an article is its market value expressed in terms of money. Market value is power in exchange. The price of an article or service, therefore, is an expression in terms of monetary units of the power which that article exercises in exchange on the market; that is, of the money it will "buy," and hence, ultimately, of the goods and services for which it can be exchanged.

The process of price formation and the type of pricing policy adopted differ importantly depending upon the structure of the market which various individual sellers face. Two aspects of the market situation may be stressed particularly; the number of sellers—whether there are many, few, or one;

and the relationship of the products offered by the seller—whether they are the same or differentiated. The basic characteristics of the market within which the business sells, coupled with the conditions of production, will determine the nature of the demand for the individual firm's product. Thus price formation will differ according to the various types of market situations.

While types of markets and the methods of pricing which grow out of them are almost infinite, economists and marketing men have simplified and summarized these multitudinous market situations into four basic types. A knowledge of the essential characteristics of these typical market situations is most helpful in studying the methods of determining price in specific situations. While no more than a summary of price theory as developed in modern treatises on the subject can be offered here, this will serve as a useful background for the more detailed study of specific market price policies which is the subject of the next chapter.[1]

THE MAJOR TYPES OF MARKET

Market situations for various products range from the one extreme of pure competition, through the stages classified as monopolistic competition and oligopoly, to the other extreme of simple monopoly.

Pure Competition

Characteristics. A purely competitive market has two basic characteristics. The first of these is that the various firms selling in the market produce a single identical product, and the second is that the number of sellers is large enough that no one of them can perceptibly influence the price of the product. Because of these characteristics, a third condition is customarily attributed to purely competitive markets. The large numbers and relative smallness of the sellers make it relatively easy for others to enter the industry if they wish. This condition is called freedom of entry.

Pure competition is not a very widespread type of market in the American economy. Nevertheless enough industries approach, though imperfectly, these conditions to make the analysis of pricing under pure competition of practical significance. A monograph of the Temporary National Economic Committee listed the following extractive industries as being at some stage of production essentially competitive—agriculture, lumber, bituminous coal, petroleum production, and fisheries. In addition a number of manufacturing industries

[1] For a more detailed study, the student is referred to the standard texts upon economic principles.

were listed as essentially competitive including such fields as cotton textiles, woolen and worsted goods, various types of clothing, boots and shoes, and many food products.[2] Moreover, even though pure competition is not very common, pricing is relatively simple here and so certain fundamentals common to all markets stand out more clearly than they do in the more complex market situations.

Influence of Demand. Under pure competition the essential concept is that the seller is completely dominated by the competition of other firms the actions of which it cannot directly influence. Since each firm is relatively small, it cannot influence market price appreciably either by increasing its own supply to the practicable limit or by withdrawing its supply from the market. If the seller tries to obtain a higher price than other sellers, buyers will simply shift to other sellers. Since the products are identical, buyers lose nothing by shifting. Nor will the price raiser's product be missed since it is only a small portion of the total market supply. Similarly there is no advantage to the seller in lowering his price below the market price since he can sell all he can produce at the market price anyway. Thus firms operating under pure competition must sell at a market price established as a result of the supply put on the market by all producers and the demand afforded by all buyers of the product.

Influence of Cost. Since market price is determined in an impersonal market over which the seller has no control, actual market price at any given time may be above or below the costs of individual sellers. Adjustment by the individual firm to the current market price must be entirely in terms of variations in output so as to minimize losses or maximize gains. No action it can take will have any effect on the demand for its individual product. Over the long run, however, it is clear that the price must be high enough to cover all the costs of making and marketing as much of the product as the buyers demand at this price. If prices fall below this point, production will decline as individual firms reduce output or leave the industry. As the available supply is reduced, a point will be reached at which some of the buyers with a more intense desire for the product will offer a higher price in order to obtain enough of the smaller supply now offered for sale. This increased competition among the buyers will raise prices to a point which will cover the expense of producing and marketing a sufficient supply to meet their demands.

On the other hand, if prices offered to producers reach a point above the costs of production a greater volume will be produced and offered for sale,

[2] Clair Wilcox, *Competition and Monopoly in American Industry*, Monograph No. 21 (Washington, D.C.: Temporary National Economic Committee, 1940), pp. 20 ff.

because producers will want to take advantage of the higher price in order to obtain greater profits. This will continue until the increased supply, caused by the higher price, will no longer be taken off the market at that price by the buyers. Then competition among producers to sell their surplus goods will again force prices down toward a cost-covering level.

Thus in a smoothly operating competitive regime, an equilibrium price will tend to be established which will equate the supply and demand for the product at the largest possible level consistent with just covering the costs of the marginal seller, and at the same time meeting all demands of buyers including those marginal buyers who find it just worthwhile to purchase at the equilibrium price.

Price Determination. The basic mechanics of pricing under pure competition may be illustrated by means of Figure 26-1. The price for the product of

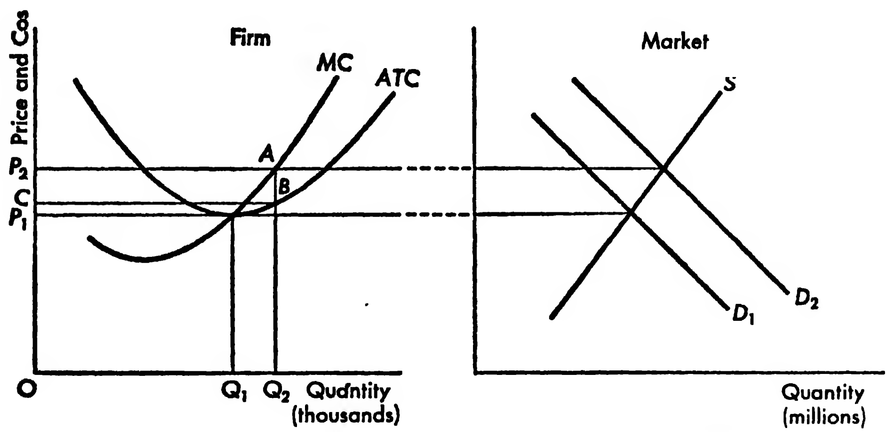

Figure 26-1. Price Determination Under Pure Competition.

the industry is determined by the aggregate demand and supply of large numbers of buyers and sellers facing one another in the market. Initially we may suppose this price to be P_1 given by the intersection of D_1 and S, the industry demand and supply curves.

This price level in turn determines the price and level of output or sale of the various individual firms in the industry. The level of output will be set where the marginal cost, MC, of the firm is just equal to the marginal revenue.[8] Since marginal revenue is the same as price under pure competition (changes in output by an individual firm have no effect on price) output will

[8] Marginal cost is the additional cost involved in producing an additional unit of product, and marginal revenue is the addition to total revenue from the sale of an additional unit.

settle at Q_1 where $MC = P_1$. At equilibrium this price will just cover the average total costs, *ATC*, of the marginal firm in the industry.

This equilibrium might be upset by either a change in total industry demand or a change in cost conditions. For example, an increase in total demand to D_2 would raise price to P_2. Firms in the industry would respond to the higher price by increasing output to Q_2 according to the marginal cost curve *MC*. The reason for this is that *MC* represents the short run supply curve of the firm since the company will find it worthwhile to incur the added costs of marginal units of output up to the point where the price received is just enough to cover the added cost. P_2 would, of course, represent only a short-run equilibrium since the existence of profits such as P_2ABC would attract additional firms into the industry over the longer run (or result in larger scale output by existing firms), so increasing total industry output. This would move the industry supply curve, *S*, to the right, bringing lower prices and eliminating profits of the marginal firms.

Pure Monopoly

Characteristics. At the opposite extreme from pure competition is pure monopoly. Pure monopoly occurs when a producer controls the output of a product for which there is no substitute so similar that the monopolist's sales will be affected by price changes in a substitute product. Thus in cases of pure monopoly the firm has no direct rival and also faces no product or groups of products which are closely competitive.

Monopoly may arise from a number of causes which prevent other firms from offering close substitutes. Among these are: legal barriers, such as patents or public utility franchises; ownership of the key resources, for example as in the molybdenum or nickel industries; the heavy investment required to start a new firm; and the threat of price warfare or imposition of other handicaps on potential entrants.

The definition of pure monopoly indicates that, like pure competition, monopoly in this extreme form is relatively rare. Nevertheless the conditions are met closely enough in a number of important areas of the economy for the case to have practical significance. A monograph of the Temporary National Economic Committee listed the following products or services which in 1937 were completely or nearly completelv controlled by one firm: [4]

Aluminum (Aluminum Company of America)
Nickel (International Nickel Company)

[4] Clair Wilcox, *op.cit.*, pp. 69 ff.

Molybdenum (Climax Molybdenum Company)
Magnesium (Dow Chemical Company)
Shoe Machinery (United Shoe Machinery Corporation)
Glass Container Machinery (Hartford-Empire Company)
Scientific Precision Glass (Bausch & Lomb Optical Company)
Domestic Telephone Service (American Telephone & Telegraph Company)
Transoceanic Aviation (Pan American World Airways, Incorporated)
Pullman Cars (Pullman Company)

and in certain areas:

Oil pipe lines
Railway freight transportation
International cable and radio
Public utilities

It is interesting to notice that the list has grown substantially shorter since 1937. Aluminum is now produced by two large additional firms, Kaiser Aluminum & Chemical Corporation and the Reynolds Metals Company, and several smaller firms. Scientific precision glass is now produced by Argus and others. Several firms have now entered transoceanic aviation. Monopoly in glass container machinery has been broken by court action.

Pricing Under Monopoly. The essential idea of pure monopoly is that the firm is not subject to the competition of any other producer of the same product and that there are no satisfactory close substitutes. The monopolist's sales remain unaffected no matter what any other producer does. The monopolist's demand is thus equivalent to the industry demand and, subject only to his finding it out, is quite definite. Moreover, since the monopolist's demand curve and the industry demand curve are identical, the monopolist's position is such that as he lowers price he will sell more units of product and as he raises the price he will sell fewer. Thus a monopolist is in a position to look for the combination of price and output which promises him the greatest total difference between cost and revenue, or in other words the greatest total profit. This means that contrary to the purely competitive seller, who simply sells at the market price, the monopolist can deliberately select a *price policy* of his own. He has discretionary power over price and output.

Limitations on the Power of the Monopolist. It is sometimes forgotten, however, that the power which the monopolist is able to exercise over the price he will charge for his product varies greatly under different conditions. The significant point to recall is that when the monopolist raises his price he will, with minor exceptions, lose sales. Whether he will receive a larger total

revenue by raising price depends, therefore, upon whether the drop in the number of units sold is more than offset by the rise in price.

This elasticity of consumer demand is determined by the intensity of desire for the product, the relative closeness of possible substitutes, and the extent of income. If salt could be monopolized, as it has been at times, the inelasticity of the demand resulting from the vital need for the product and lack of close substitutes would make it possible for the monopolist to raise the price to unheard-of heights. Similarly there would be no limit, save his resources, to what the consumer would pay for water if an uncontrolled monopoly sold it to maximize revenues. If sugar, on the other hand, were monopolized, consumers might pay a much larger share of their income for it than they are now in the habit of paying, but a point would soon be reached where they would go without sugar, substituting corn syrup, maple sugar, or perhaps even go without sweets of any kind. If the necktie market were monopolized and prices raised, a point would be reached relatively soon at which many consumers would begin to go without neckties or would substitute other ornamentation.

Thus the price policy of the monopolist must be determined with such considerations in view. The monopolist has little definite knowledge with which to start in his effort to obtain the greatest margin between total expense and total income. He may know his costs of production and marketing, although if his is a business of increasing or decreasing cost he cannot know even this with accuracy. He does not know what reaction he will receive from the consumer at different prices, except after trial. Of course, if he is wise, he will study his market so as to estimate the best price with as much accuracy as he can, but aside from that he must experiment. Probably few monopolists, if any, have ever arrived at the one best price for their article, and if they did, the price would be but temporarily the best, for conditions affecting expenses, demand, wants, and income are constantly changing. Furthermore, many firms possessing a monopoly, or even a degree of monopoly, have never tried to exercise their power to the limit. Ignoring any more altruistic motives which may influence them, this may be due to their fear, for example, that competitors will be induced to enter their market, that substitution will take place, or else for fear—generally in the case of important commodities of everyday use—that popular indignation will force the government to take a hand.

Price Determination. Pricing under monopoly conditions, and the monopolists need to keep in mind the effect of different prices on total profits, may be illustrated diagrammatically by Figure 26-2. The demand curve, *D*, shows that an increased output can be sold only at a decreased price. Thus the change in

total revenue resulting from the sale of one additional unit is the result of adding to the total the receipts from the sale of the added unit, and subtracting the loss of revenue on all other units sold because of the lower price at which they now sell. This result is given for any level of output by the marginal revenue curve, *MR*.

Thus under the demand and cost conditions depicted in Figure 26-2, the monopolist would set price at P_1 with output Q_1, a position determined by

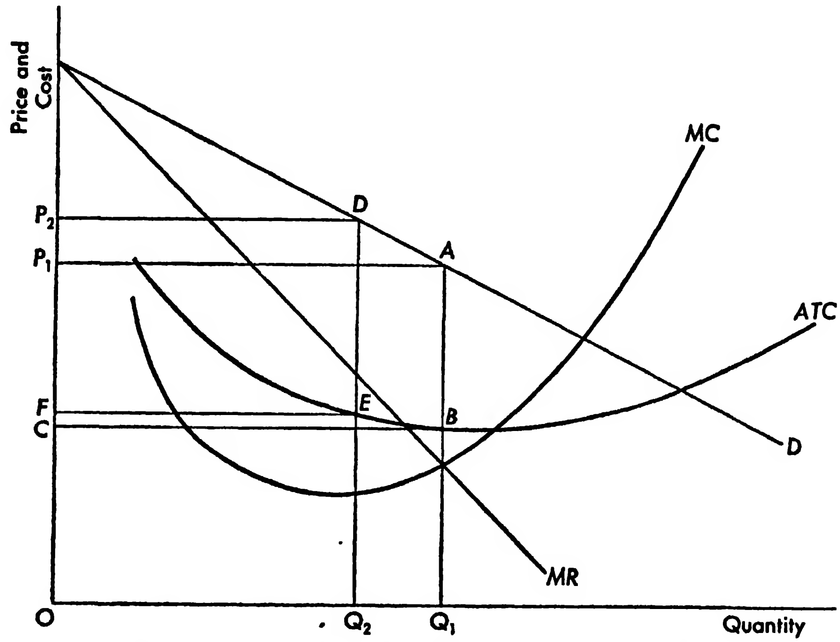

Figure 26-2. Price Determination Under Monopoly.

the level at which $MR = MC$. That total profit P_1ABC would be at a maximum at this point is evident if alternative prices are considered. For example, the monopolist could charge a higher price such as P_2 (an alternative not open under conditions of pure competition). Total profit P_2DEF would be less than at price P_1 since at this output the monopolist could increase his profits by lowering his price. The added revenue from the larger sales, as given by the curve *MR*, would more than offset the added cost of the higher output, as given by the curve *MC*. This would be true up to the point where *MR* just equalled *MC* at P_1Q_1. Beyond this level of output the added revenue from larger sales would be less than the added cost, i.e., *MC* is greater than *MR*, and total profits would become smaller.

Monopolistic Competition

Neither pure competition nor pure monopoly is particularly common in the American economy. Considerably more widespread is the type of market structure which has become known as monopolistic competition.[5] As the name implies, elements of both competition and monopoly are present in such situations.

Characteristics. One condition, taken from pure competition, is that there be a large number of sellers of the particular class of commodity. In other words no seller controls a large enough proportion of the total market sales so that by increasing or decreasing his output he will affect the sales of any other seller enough to induce a reaction.

The second condition, similar to that for pure monopoly, is that the firm produces a good which is significantly differentiated in the minds of consumers from the closest substitutes. Since no other producer exactly duplicates his product the seller under monopolistic competition is to that extent a monopolist. The real difference between his position and that of the pure monopolist is one of degree. The product of the pure monopolist has no close substitutes while that of the firm under monopolistic competition has a number of close substitutes.

The basis of differentiation between the similar products of sellers may be real or imagined. All that is necessary is that the difference seem important to at least some consumers. Individual producers will then have some control over the prices at which they sell. That is, like the pure monopolist, the producer under conditions of monopolistic competition must have some price policy. With a rise in price he will not lose all his customers as he would under pure competition. Yet the fact that there are relatively close substitutes for his product means he must be careful, for as his price rises his customers are likely to shift relatively quickly to other sellers. The closer the substitutes are the more elastic the demand is; or in other words, the smaller the price change which will bring about a shift of consumers between sellers. It is clear that the nearer the products of different sellers approach to being perfect substitutes the nearer the market is to pure competition, while the more imperfect the substitutes are the closer the market is to pure monopoly.

[5] The term as originally introduced by Professor Chamberlin had the more inclusive meaning of all types of markets between pure competition and pure monopoly. Edward H. Chamberlin, *The Theory of Monopolistic Competition* (Cambridge: Harvard University Press, 1933). (There have been a number of succeeding editions.) The narrower meaning of the term as used here has become more common in recent years.

Degree of Control. Conditions approximately satisfying those for monopolistic competition exist, for example, in many types of grocery and drug products. When the consumer has been in the habit of purchasing a particular brand of goods for years it may take a considerable rise in the price of the product or fall in the price of competitive products to induce him to change his brand. The seller, through national advertising, local advertising, the use of salesmen, or the cooperation of middlemen, and by producing a satisfactory or superior product, creates in the buyer a desire to buy his particular brand. Then even though competing products may be as good as his own, insofar as he is able to induce buyers to ask for and insist on getting his product, he has a degree of monopoly of his market.

Moreover, regardless of his sales efforts, any seller whose goods have proved satisfactory to buyers has a certain advantage. They know and like his product. Why should they experiment with others that may prove to be less satisfactory or even entirely unsatisfactory? Influence of this sort does not, as has been pointed out, usually carry with it any large control over prices. For if the price is much higher than the price of competing products, many buyers will purchase competing commodities or go without. But so long as price and quality remain approximately the same, the created demand will combine with the established custom as well as with the desire and convenience of the purchaser and help assure to the seller some degree of control over his market.

Once the customer is won over and finds the product satisfactory, he ordinarily continues to buy that product over and over again. It is these "repeat sales" that make economical much of modern selling. Large-scale sales promotion is profitable only if, once a sale is made, repeat sales follow. The cost of the initial sale is then gradually spread over the later sales.

Necessity for a Price Policy. These statements emphasize again the fact that the seller under monopolistic competition must have a price policy. He cannot, as under pure competition, simply sell at the prevailing market price. The buyer under monopolistic competition has no alternative source from which he can obtain exactly similar products. He must pay the price or go without the product. For the seller of a differentiated product there is no true prevailing market price. Hence there is no prevailing price at which he can sell his product if he offers it for sale and no assured sales if he reduces his price. True, the more nearly his product is like competing products, the more likely it is that he will be able to sell at the same price offered by competitors, or at a lower price. This is particularly true if purchasers *know* that the products are similar. But where real or presumed differences exist between

products, a "competitive" price alone will not assure a satisfactory volume of sales; selling effort may also be necessary. This is evidenced, for example, by the fact that the price charged by department stores and chain drug stores for their own brands of a common drug, which has been popularly identified with the name or trade-mark of some manufacturer, must frequently be considerably below that of the better known brand of the product.

Use of Nonprice Competition. Finally, it is well to recognize that, while price competition in the sense of "pure" competition does not exist in the sale of such products, competition in the sense of striving for sales is in many instances most intense. This nonprice competition differs from pure competition in that it is not confined to a pure price basis. Nonprice competition can result from a wide variety of influences. For example, the continuous introduction of new and different products has brought intense inter-industry competition as producers of different types of products struggle for the largest possible share of the consumer's dollar. Similarly, improved methods of production as well as improved transportation and communication have brought increasing volume of production and have opened up new areas from which products can be shipped to given markets, thereby intensifying competition both among those who sell similar articles and also among industries. Identification of products opens up the possibility of competing on the basis of quality and service with prices ranging from low prices for minimum quality and service through various ranges of prices to very high prices for a maximum of quality and service; and any one producer may choose between selling one quality of product at a price or he may sell several products, differentiated by their qualities and marks of identification, at several prices.

It is difficult under conditions of monopolistic competition to be sure where price competition leaves off and nonprice competition begins. The difficulties arise primarily out of the problem of defining price. This is a matter largely of the fact that there are many conditions attending the sale of a product, and it is not easy to determine which should be considered as contributing, at least indirectly, to the sale of the product but are not part of the item actually bought. Probably the most satisfactory way is to define price as a package which includes all the items surrounding a sale for which a monetary value can be approximated. This would include the quality of the product and the terms of sale such as place. time, and conditions of delivery and payment. This leaves under nonprice competition only those procedures and expenditures surrounding the sale which affect the buyers' subjective valuations of the product or seller. Such a distinction means that nonprice competition includes primarily the various forms of sales promotion such as

advertising, personal selling, fashion and model changes, and especially in recent years the use of trading stamps.[6]

The distinctions just made between price and nonprice competition are certainly not clear-cut in every case. For example, the salesman of industrial goods may provide valuable engineering or installation services. The annual model changes for automobiles are a melange of style and quality which will not always separate neatly into those for which a monetary value can and cannot be assigned. The price of meals at a restaurant provided for customers by a department store probably does not cover all the values derived from it by either the store or its customers. Nevertheless, the distinction is a valuable one in spite of its lack of precision in all cases since it provides us with a way to distinguish and analyze the elements surrounding the sale of goods.

Price Determination. The diagrammatic representation of pricing under monopolistic competition does not differ formally from the case of pure

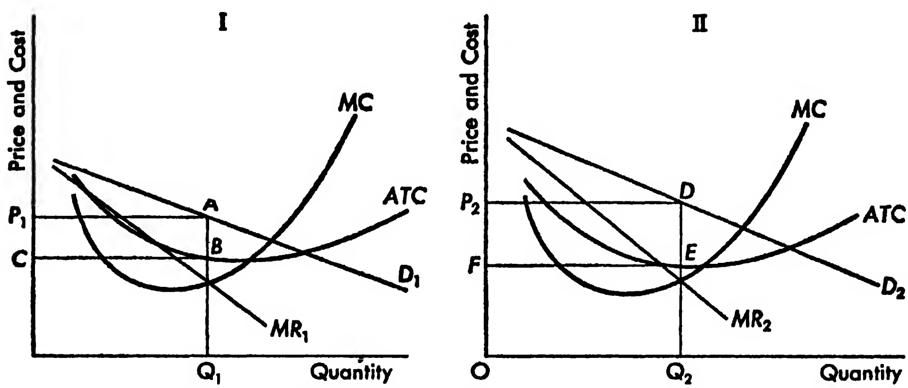

Figure 26-3. Price Determination Under Monopolistic Competition.

monopoly so long as there is no change in the demand curve. Recalling the importance of nonprice competition under monopolistic competition, however, it is important to recognize that the demand curve is much more likely to shift under conditions of monopolistic competition than of monopoly. This might occur either because of selling efforts of the firm itself or because of the impact of the actions of other firms selling the same general type of goods.

Thus in Figure 26-3 during period *I* the position of maximum profit is output OQ_1 and price OP_1 giving a profit of P_1ABC. By means of some form of nonprice competition, for example an intensive advertising campaign, the firm may be successful in shifting its demand curve to D_2. The new position

[6] These forms of sales promotion are discussed in Chap. 18.

of maximum profits would be output OQ_2 and price OP_2 giving the larger total profit of P_2DEF.

Oligopoly

Perhaps most common in the American economy is the last type of market structure called "oligopoly," or "small numbers." In such markets the number of firms selling a similar product is small enough so that each sells a substantial share of the total output. Under such circumstances any one of the firms can, by a change in its output or price, affect the sales of its competitors by a noticeable amount. The rival firms are then likely to react with changed price or output policies of their own, which will in turn alter the sales of the first firm, which may in turn induce a further reaction by that firm, and so on. These have aptly been termed "boomerang" reactions.

The basic feature of oligopoly is thus a mutually recognized interdependence of rival sellers' price and output policies. This circumstance also signifies an important difference from each of the other market structures mentioned previously with respect to the demand situation facing the seller. Under pure competition, pure monopoly, and monopolistic competition, the seller faces a definite demand situation which at least conceptually he could discover. This is not so under oligopolistic conditions, assuming no collusion among the sellers. An independent price change by one seller tends to begin a boomerang chain of repercussions. These will ordinarily have no definite and predictable outcome because the various counter adjustments depend upon each oligopolist's guesses as to the most probable reactions of his competitors.

It is clear that there is much uncertainty in the market situation facing oligopolists. An oligopolist acting independently of the other firms cannot be sure what will happen if he decides to initiate a price or output change. While conceptually there are an indefinite number of possible reactions which the oligopolist might have to consider, for present purposes it will suffice to suggest two or three major possibilities.

There are two major classifications of oligopolistic market situations—pure oligopoly in which the firms sell identical products, and differentiated oligopoly in which the firms sell products which are close but not perfect substitutes. The two classifications between them cover a very large portion of the American economy ranging in size and significance from the automobile industry to three drug stores located close together in a suburban shopping center. A partial listing of some of the more important oligopolies will indicate how widespread and important oligopolistic markets are. Among the pure oligopolies are aluminum, chemicals, steel, copper, lead, cement, sulfur, and

many others. Differentiated oligopolies include such fields as automobiles, cigarettes, soap, electric appliances, gasoline, and others.

Pure Oligopoly. Under conditions of pure oligopoly, as under pure competition, sellers must charge identical prices to remain in business. Generally speaking there are, therefore, two types of reactions by rivals to a seller's independent price cut. One possibility is that his price cuts will be just met by his rivals. Assuming the cuts are made simultaneously, then essentially the price cutter can look forward simply to his more or less regular share in an increased total industry demand. If, on the other hand, his price cut is expected to set off a series of retaliatory price cuts, then there is no simple prediction of the effect on his sales. He must instead try to estimate the probable outcome of a price war in which, for example, financial resources may be the deciding factor. Similar uncertainties will exist with respect to price increases. The firm may, for example, hope that his rivals will follow him in a price increase, but recognize that if they do not his own sales will be drastically reduced.

These difficulties facing independent price and output policies tend to lead oligopolists to make explicit agreements about pricing and market policies, or to follow conventions which, one way or another, coordinate their price policies both as to level and timing. Under the antitrust laws, formal price fixing or market sharing agreements are illegal in the United States. Perhaps the most common way of avoiding the uncertainties of an independent pricing policy is the recognition by the industry of one firm as the price leader. The price leader is expected to make the decisions with respect to price and its lead is followed by the other firms in the industry. In effect this makes an industry of nominally independent oligopolists similar to the case of simple monopoly. The manipulation of price by the price leader, however, is much less simple than for the pure monopolist. Some uncertainty always exists, since one or more firms may feel their interests are not being properly met by the price leader and may openly or secretly break away from the customary pattern of behavior. The situation is thus much less stable than in the case of pure monopoly.

Differentiated Oligopoly. The second type of oligopolistic market structure involves the sale of differentiated products. Many of the considerations relevant to product differentiation have already been discussed in connection with monopolistic competition and need not be repeated here. Certain distinctions important in distinguishing pure and differentiated oligopoly may be mentioned, however.

The major differences between differentiated oligopoly and pure oligopoly

are two. First, the several firms may find they are able to charge somewhat different prices for their products without the reaction from competitors which would automatically follow with an undifferentiated product. Generally, however, this range of pricing policy will be relatively narrow.

The more significant difference lies in the fact that selling costs are much more important in differentiated oligopoly than in pure oligopoly. Selling cost may take one or more of several forms of quality and nonprice competition. While very significant for monopolistic competition, they are especially important here because changes in the various forms of nonprice competition by one oligopolist are likely to bring competitive reactions from his rivals. Most significant from a general point of view is competition in terms of product development and product variation. This type of competition seems particularly strong under differentiated oligopoly. Much of the improvement in consumer goods over a period of time both in quality and variety is undoubtedly due to it. The development of the automobile offers an excellent illustration of this. It may also, of course, result in less useful changes, such as periodic style changes to make older models obsolescent without real changes in quality.

Other aspects of nonprice competition are advertising and sales promotion. Both may be most helpful in making known new products or bringing other important information about products to potential buyers. It is also true that in many cases these practices have enabled firms to grow to a size where there are important cost advantages from large-scale production. On the other hand, there is sometimes a tendency in oligopoly for advertising and selling costs to become merely competitive and largely self-canceling without adding to the output of the economy or the welfare of buyers.[7]

GENERAL FACTORS AFFECTING PRICING IN THE VARIOUS TYPES OF MARKET STRUCTURE

The influence of market structure on price and output procedures in different situations has been shown to be most important. Likewise important in greater or lesser degree to all types of market structures are certain general influences or practices which modify for varying periods of time the results which might otherwise be expected. A few of the more important of these are: (1) the failure to forecast conditions of production and trends in demand accurately (inaccurate forecasting), (2) the failure of businessmen to enter or leave the market quickly when prices are unfavorable (fixed costs, variable

[7] See Neil H. Borden, *The Economic Effects of Advertising* (Homewood, Ill.: Irwin, 1942).

costs, and unused capacity), (3) custom and convenience, and (4) government control.

Inaccurate Forecasting

The common inability to forecast accurately conditions of production and trends in demand causes market operators to assume varying degrees of risk, to speculate. Speculative prices prevail throughout the business world. In a sense, all prices are speculative, because knowledge of the actual conditions which will prevail on the market at a future date, near or distant, is never complete. Even the most perfect news service cannot report the many changed situations that may arise between the time the market is forecast and the time the prospective exchange actually takes place. Not only may changes occur in conditions affecting production, such as change in the weather, floods, frosts, and pests, or improvement in methods which result in cheaper processing or better products, or both, but changes in demand likewise arise. A panic, a war, a depression, a new product or method, a fashion change, may, one or all, alter the nature and amount of the demand for goods.

The interaction of market forces is so complex, and the apparently extraneous circumstances which have, nevertheless, a considerable effect are so many, that an accurate estimate of market conditions which will prevail at a future date is often practically impossible. This is particularly true of items requiring long periods for their production and of items for which the demand is more or less precarious and elastic—as with seasonal fashion goods. These conditions prevail to a large degree in the market for most machine-made products, and similar problems arise in the market for farm products. There are, consequently, likely to be alternating gains and losses on the market. These result from over- or underestimation of the market demand or supply, and cause gain or loss, greater or less according as the estimates are more or less remote from the actualities which develop later.

Fixed Costs, Variable Costs, and Unused Capacity

The reasons for the inability or unwillingness of businessmen to enter or leave a market are so numerous that they can only be suggested in this discussion. But it can be stated as a general principle that, although changes in price may have an immediate effect on the volume sold, changes in the volume produced and in plant capacity are seldom made in immediate response to price changes. They are likely to be long delayed, sometimes for

years. And when demand falls off or increases, price changes do not always follow immediately.

One of the fundamental reasons for this delay is the importance of fixed or overhead costs in modern industry. The total cost of producing and marketing an article is made up of variable costs and fixed costs. Variable costs, as the name implies, vary directly with the volume of business. They include such items as the expenditures for labor, raw materials, fuel, supplies, and fabricating parts used in making a product. Fixed costs, on the other hand, include relatively fixed expenses such as the expenditure for interest on the investment, taxes, insurance, executive salaries, and allowances for depreciation and obsolescence. Although some of these expenses may be reduced if production is curtailed, such reductions are not in proportion to reduction in volume, and most of the expenditures remain fixed as long as operations continue and the business remains solvent. On the other hand, an increase in volume is often possible only after increases in overhead expenses are undertaken which may be proportionately larger than the anticipated increase in sales.

Effects on Pricing. The fact that most business firms have expenses that remain fixed or do not alter in direct proportion to the volume produced has important effects on pricing. Manufacturers have large investments in plant and equipment and a high-salaried personnel, and farmers have investments in land, buildings, equipment, and their own time spent on the farm. These expenses do not vary over the short run and frequently do not vary for long periods of time even with considerable variation in volume. The actual cost of such expenses must be borne by whatever volume is produced. If production approaches the optimum capacity these expenses can be spread thinly over a large volume and average fixed costs will be relatively small. If production is less, then average fixed costs are increased.

Effects on Output. When prices fall to a point that does not cover average total costs, efforts are likely to be made to curtail the variable costs—by improving methods, reducing waste, reducing wages—but when all possible economies of this type have been made a firm's fixed costs continue, and it may still be faced with losses. The firm that must pay heavy fixed charges may find its losses will be reduced if it continues to produce and to sell—even at a loss—if the price will cover its variable costs and still leave something over to help meet a part of the fixed costs.[8] It may even find that when prices

[8] If this point needs clarifying, recall that even if the firm does not produce, its fixed costs will still continue. Therefore, anything it can get toward covering even a part of these fixed costs is better than nothing. Thus to produce at a price which covers not only variable costs, but also part of fixed costs will mean a smaller loss than not to produce at all.

are low it can reduce its fixed costs per unit by *increasing* the volume produced. Variable expenses per unit will not begin to increase until optimum capacity is reached, but fixed expenses per unit will decline as the volume produced increases. This will result in increased profits or a reduction in losses.

A farmer faced with falling prices for his major cash crops, for example, may increase his acreage of the cash crops and thus increase his cash income at prevailing prices. Such a policy may be unwise in the long run—his soil may deteriorate, and, as other farmers may follow the same policy, total production will be increased and prices fall to a still lower level. But faced with the need to pay interest on the mortgage, make the instalment payments on his tractor, and the natural desire to keep his income as high as possible, he is prone to increase his production. Even when a given firm becomes bankrupt, or is sold at a loss, its production is not necessarily withdrawn from the market. It is more likely to continue to operate, and with its fixed charges now reduced it may become a low-cost producer and so undermine the business of formerly successful firms that have been able to operate profitably.

When prices are high, a firm operating with heavy fixed charges will hesitate to increase its capacity in order to take advantage of the higher prices, unless it is reasonably sure that they will continue to prevail until new equipment or a new plant can be placed in operation and long enough thereafter to regain the investment.[9] Since fixed charges prevail in some degree in all modern production this is a universal consideration, but one of varying importance.

Price Expectations and the Level of Production. The existence of overhead charges is not the only element retarding the influence of prices on production. If price declines are expected to be temporary a firm selling branded products may reduce prices and sell at a loss, in order to keep its products before the public and so to retain the good will it has developed. Firms with or without brands may continue to operate under such conditions in order to keep their organization together. Even if price reductions are expected to be permanent, firms may continue to sell at a loss for a time in order to hold their markets until improved methods of production enable them to reduce costs, or until improvements in their products or in methods of selling enable them to sell for higher prices. In many such cases, however, and particularly in the case of differentiated products, the most important effect of a declining market is to reduce the volume that can be sold at the existing price. This is the case

[9] This is not a complete analysis of this point, of course. Certain overhead charges, for example, which can be increased or decreased if large changes in volume make such changes desirable, must be considered with fixed charges at any given time; and obviously, if a given increase in volume is expected to be permanent, the recovery of expenditures for fixed investment becomes of minor importance or may be ignored entirely.

because some firms will prefer to sell at the old price until improved production methods enable them to reduce prices, or until improved products or improved marketing methods enable them to increase the volume sold at the old price. As has been pointed out, for such manufacturers, as well as for wholesalers and particularly for retailers, competition is manifested in many ways, not only in price but in nonprice aspects as well: for example, improved quality or service, attractive packages, modern store buildings, effective selling and advertising, and convenient terms of payment.

Perishable products fall into a different category. They cannot be held off the market for long. Owners of an existing supply have no alternative other than to sell at the prevailing prices or, if cooperative effort on a large enough scale is possible, to keep some part of the supply off the market and thus bring an increase in the price of the volume that is marketed.[10]

This has sometimes been done by producers of farm products working cooperatively or under governmental control and assistance. Much the same result was accomplished before World War II by the federal Surplus Commodity Corporation, which purchased "surplus" supplies to market through other than the usual commercial methods. The curtailment of production of certain farm products through the activities of the federal Agricultural Adjustment Administration and related agencies has carried back to the field of production these efforts to reduce the volume offered for sale.

Customary and Convenient Prices

Variation in prices by sellers to meet changing conditions is frequently limited by custom and convenience. Dealers become used to charging certain prices, and consumers become used to paying them, and whether expenses go up or down, often within wide limits, prices remain the same. Mere inertia is a strong factor in pricing. This is especially true ot retail prices, which by no means conform to the many and frequent changes in wholesale prices. A grocer may sell a pound of coffee for 79 cents for months, whereas the actual price he, or his wholesaler, pays may vary nearly every week; but very often only a considerable change in the wholesale price, which appears to be relatively permanent, will induce him to change the retail price. The 5 cent price was so firmly established for many candy bars and soft drinks, that in spite of

[10] The effect of such efforts on the total income of a given producer is seldom clear, for the increased price for the smaller volume may not amount to as much as would the sale of the entire output (already produced, usually, in the case of farm products) at a lower price. A particular producer, for example, may have only a small proportion of his entire crop falling into the classes to be marketed. If the product to be held off the market is still in the fields, however, the cost of harvesting and marketing the part withheld is saved.

almost continuously rising costs from the middle thirties into the postwar period sellers tried almost every expedient to avoid increasing the price. Such prices make marketing much simpler to both seller and consumer, reduce price bargaining in small purchases, and eliminate bargain hunting for the products and services of ordinary consumption. Customary prices are convenient to the dealer and to his customers.

Government Control of Prices

The powers of government are also used to influence prices. Monopolies of goods or services of peculiar importance to the welfare of the general public are sometimes owned by the government; and they are usually at least subject to public control of rates and services. The operation of public utilities, for example, is naturally monopolistic, because of the inconvenience to the public of competition (for example, two or more separate telephone systems in the same area) and because it involves the economies of large-scale production, including the elimination of the wastes of duplicate competing plants. Public utilities are usually controlled to protect consumers against exorbitant prices, and to assure extensions of the service to parts of the community where it is socially desirable to have the service, but where a private firm might not find profit in extending it, and so where it would not be carried if no control were exercised.

In the great majority of industries government ownership or control is considered undesirable. For these industries antitrust laws have been devised to protect consumers as well as small competing firms against the abuse of monopolistic powers when they are exercised by large firms or combinations of firms.

It has been rather common to think of governmental effort in relation to prices as one of regulation, with a view to protecting the consumer against unreasonably high prices. But governments, perhaps with increasing frequency, often attempt to influence prices with a view to raising them, or at least with a view to protecting the interests of someone other than the consumer. Protective tariffs, for example, commonly result in higher prices, and recent efforts to curtail the production of certain farm products, the purchase of "surplus" commodities, and loans at support levels by governmental agencies have the increase of prices to growers as their primary objective. And of course many other governmental activities affect prices directly or indirectly. Taxes obviously affect prices; control of railway and trucking rates intended to prevent cut-throat competition, rebates, and similar practices certainly result in increased rates, at least in the short run. And, such laws as the Robinson-

Patman Act, the state "fair trade" acts, and state "loss-limitation" acts, all have a definite tendency to raise some prices at some points, and many believe that they have a general price-raising tendency.[11]

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[11] Some of these effects are discussed in more detail in Chaps. 28, 29, and 30.

27. PRICE POLICIES

The prices set in the market are the central phenomena of a free market economy. Their basic role is the guidance of economic life. In a price-directed economy the prices which consumers are willing to pay for various goods and services and the amounts which they will take off the market at those prices are the ultimate determinants of how the available economic resources—land, labor, and capital—will be distributed among the various possible uses.

Thus prices perform a service of the highest importance to the proper functioning of the economy. They are also of highest importance in the success or failure of the individual firm. In the preceding chapter the influence of differences in market conditions on the pricing process was summarized. It was pointed out that, aside from cases of pure competition, businessmen frequently are able to exercise a considerable range of choice in deciding what steps should be taken to meet their particular market situation. This circumstance requires businessmen to formulate some type of policy with which to determine the "best" price in their situation.

It is important to realize that pricing is a major aspect of the over-all marketing policy of any firm. Oxenfeldt has pointed out that "Price is far more than a rationing device that determines which potential customers will be able to afford to make a purchase. Generally it is one of the most important actions in creating an impression of the firm among potential customers." [1] The over-all aim of the pricing policy of any manufacturer or middleman is essentially the same as the over-all aim of the firm, namely, to aid in maximizing total profit over time.[2] Depending upon the kind of product and the market circumstances, many factors may have an influence on the price finally determined.

[1] Alfred R. Oxenfeldt, "Multi-Stage Approach to Pricing," *Harvard Business Review*, July–August 1960, p. 133.

[2] Much pricing theory assumes that the goal is short-run maximization of profit. The more choices of price which a firm has the less acceptable this assumption becomes as an approximation of reality.

For example, there is the question of whether the price set is consistent with the kind of market in which the firm is best suited to sell. A retailer may already be well established with a particular clientele, perhaps people who are highly price conscious and who are satisfied with only moderate quality. He will wish to keep his prices and the type of products he sells in line with the expectations of his regular customers, and ordinarily not introduce high-priced "exclusive" lines. A manufacturer of lines of high quality must recognize the possibility that, if he introduces a low-price line of lower quality, he may obtain high sales and profits in the short run by drawing on the reputation of his high quality product, but that in the long run he may drive away the customers who were his original strength and perhaps lower his long-run profits.

Again, a middleman's pricing decisions must be taken in conjunction with the over-all decisions of how much to spend for advertising, how much for salesmen, how wide an assortment of similar products and how heavy an inventory to carry, and how frequently to vary the price to meet market conditions, for special sales, or similar purposes. A manufacturer may be concerned in addition with such questions as the relation of his price to dealer loyalty and the type of distribution system he is using or planning to use, whether he must expect to change his product periodically, the effect of his pricing policy on his rate of sales and through this on his costs, the reactions of his rivals to the price he sets, whether he should use "fair trade" pricing, and similar considerations.

Thus it is vital that a firm's pricing policies be established in a manner consistent with its over-all method of operation and objectives. Pricing has a major impact on the effectiveness of the firm's advertising and selling policies, and on its cost and production or sales capabilities. The pricing policies should therefore be established within a framework of rules which assure that account is taken of their effect on the other aspects of the firm's marketing program.

BASIC PRICING PROCEDURES

While there is almost an infinite variety of market conditions and ways of meeting them, it is possible to reduce these into certain major classifications to show how businessmen marketing under different circumstances meet the problem of how to determine their prices. In some of these classifications the private interests and judgment of the price setter largely determine how prices are established. These situations are discussed in this chapter. In a number of circumstances, and with respect to a number of possible pricing

methods which government feels may affect the public interest, however, governmental regulation and influence are important to the decisions of the price setter. These cases are considered in Chapter 28.

Price Estimating

Where there are no general market prices, the seller frequently attempts to estimate the price which will bring him the best returns. It may be that any one of a dozen different prices will sell enough of the product to result in a satisfactory margin of profit, but it is seldom possible to tell in advance which one of these will prove to be the most profitable. In an effort to find the best price he may compare the product with similar goods which he already sells, or with the prices charged by competitors. He will consider such factors as the following: Is the general price trend up or down? Is the prevailing mood of buyers inclined toward spending or toward saving? If it is a style or seasonal good, is the peak period approaching or already past? Is close competitive pricing necessary for this particular product? A retailer may rely upon the advice of his supply houses, or upon the judgment of competent salespeople and department managers. Sometimes the manufacturers of a new product will experiment by trying out different prices in unconnected but similar markets to see which price seems to work the best.

The best price can seldom be determined accurately at the time a particular price must be determined and obviously a considerable degree of trial and error is involved. The price which the vendor sets on his products is in the nature of a trial price. With the development of the one-price policy in retail sales, with a considerable volume of wholesale business conducted on a one-price basis, and with many manufacturers attempting to set or suggest the resale price of their product, this estimate (or guess) has assumed large significance, since price cannot be easily modified to meet the conditions which develop in individual transactions. Moreover, once consumers get used to a particular price or range of prices it is difficult to make changes.

Customary Markup or Cost-Plus

Frequently the number of prices to be set by a firm will be so large as to make individual price estimating impractical. For example a retail store, or a wholesaler, may have hundreds or thousands of different items for sale. Similarly, manufacturing firms, such as large chemical, steel, or automobile companies, may have thousands and thousands of prices to set when account

is taken of all the quality and quantity variation demanded by customers for basic products, or the number of parts which must be stocked to take care of the maintenance of complex machinery. Under these conditions some form of customary markup pricing, or cost-plus pricing as it is commonly called in manufacturing, may be most practical, at least in setting an initial price. Or, sellers may have some idea of a "fair" markup which they feel should be added to cost, believing it unfair to the buyer to add more and unfair to themselves to add less.

Markup Pricing by Middlemen. Whatever the reason, markup pricing is very common. A certain markup above cost is added according to the type of good to which the product belongs.[8] This may be a definite sum, but it is more frequently a percentage of the cost price. It normally includes the estimated expense of selling that particular good or class of goods plus such profit as the vendor expects to receive. Sometimes these normal markups are accepted throughout a particular trade, or they may apply to a store as a whole, to particular departments, to particular lines, or to individual commodities.

It must be recognized, however, that a price set in this way is always tentative—to be raised or lowered as market conditions may dictate. If there seems to be a very great demand, the price may be increased, or it may be retained in order to sell a larger volume. If demand falls off, the price may be reduced in order to stimulate further demand. Sellers do not, however, always reduce prices when demand for a particular article declines. They may increase their sales efforts, or they may simply accept the small demand and make no effort to increase it. In the latter case they will thereafter reduce the volume of their output or purchases to correspond to sales, or refuse to buy additional stocks. For retailers these questions are sometimes very difficult. In the merchandising of staple lines, purchases are easily adjusted to sales in this way. Stocks can be held and slowly sold at the price marked. But with fashion goods and perishables, or with staples which are a considerable part of a merchant's line, this is not a wise policy. Fashion goods are usually bought in advance of the season, and if they do not move at the desired price something drastic must be done at once. Unlike staple lines, they cannot be held over; for as time passes they come to correspond less and less to the demands of the market, and so the longer they are held, the greater the ultimate loss that must be taken. If a greater demand cannot be created by sales effort, lower prices must be set. Goods which are physically perishable

[8] It may be noted that, when middlemen use a customary markup, in effect the price has been set by the manufacturer.

present much the same problem. The practice of drastic markdowns of prices for tomatoes, peaches, or strawberries as they approach spoilage is a result of this situation, as are some of the "drives" put on by retailers in cooperation with farmers' associations to sell perishable farm products temporarily in large supply.

Cost-Plus Pricing by Manufacturers. Cost-plus pricing by manufacturers is similar in procedure to markup pricing. Short-run variations in sales and costs are ignored and a manufacturer's calculations are based on what he expects will be his average rate of operation over a period of years, a rate which might be 70 or 80 per cent of capacity and is commonly called the "standard volume." Standard costs per unit for each product based on this volume, with overhead costs allocated according to some arbitrary system, are then calculated. Finally a margin to achieve the firm's goals is added. In regular cost-plus pricing this is some standard margin which the firm thinks, or has found from experience, will usually achieve satisfactory results. Frequently, particularly among larger firms, however, the markup for particular products will be based on a firm's predetermined profit goal, or target rate of return on investment. Other goals may be the stabilization of price and margin, achievement of a specific market share, or the meeting or sometimes the preventing of competition.[4]

Target return pricing is particularly appropriate for new products. They are less likely to have close substitutes than old products so that there is greater leeway in pricing. They can be priced in whatever way appears most likely to result in the largest profit over time, or at least over the time during which the introducer expects to have relative freedom from competitive products. Thus he may attempt to obtain high margins while demand is relatively inelastic. Or he may deliberately sacrifice this possibility in favor of penetrating a large potential market available at lower prices. Griffin, in considering price dynamics of this type, gives an example from the chemical industry.

A new synthetic fiber, for example, may be so costly and high priced that it is used only for surgical and other very limited purposes. By dropping the price in anticipation of reduced costs, the hosiery and fine apparel markets may be reached; still further down the price scale, the rug, carpet, and industrial markets may be tapped.[5]

[4] Robert F. Lanzillotti, "Pricing Objectives in Large Companies," *American Economic Review*, December 1958, pp. 922–3. Among ten large manufacturers whose goals included primarily a target rate of return, "The average of the targets mentioned was 14 per cent (after taxes); only one was below 10 per cent; and the highest was 20 per cent."

[5] Clare E. Griffin, "When Is Price Reduction Profitable?" *Harvard Business Review*, September–October 1960, p. 129.

In the absence of monopoly, however, it is evident that the prices reached by cost-plus procedures must constantly be re-examined in the light of competitive conditions. A lower price for a competitor's product may bring such sales losses to a firm that some protective reaction is necessary. This may take the form of lower prices, an effort to reduce costs, or in the case of differentiated products an increase in selling effort of some kind. If nothing else suffices, and it appears impossible to obtain a satisfactory rate of return, the manufacturer may simply drop the product. On the other hand, the cost-plus price may be lower than that of competitive products. In this case the price may be raised to get it in line, or a decision made to take advantage of the low price to pursue an aggressive market penetration policy.

Customary and Convenient Prices

Another procedure alternative to price estimating which applies to many types of products is the use of customary or convenient prices. Such pricing is common in the sale of many goods at retail. Prices can be named and change made more conveniently in "even money"—5 cents, 10 cents, 25 cents;[6] or odd prices—19 cents, 39 cents, 69 cents—such as those used with cotton yard goods, may be customary. Again, when a price has prevailed for some time, both seller and buyer come to take it for granted, as is illustrated by the experience of the manufacturers and distributors of the "nickel" candy bar both during the depression of the thirties and the inflation after World War II. With such goods even large variations in the wholesale price may cause no change in the retail price. Furthermore, if the wholesale price increases to a point that nets no profit to the retailer he may even solve the problem by discontinuing the product, or at least not featuring it, rather than by raising the price.

Similar to this is the policy of some retail stores, particularly department stores and chain stores, of determining the prices at which some of their lines are to be sold, and then purchasing goods at prices which make it possible to resell with profit at these predetermined prices. Or sometimes stores follow the policy of pricing the whole stock of the store at one or a limited number of prices, as in the case of clothing or shoe stores selling only "economy" lines. If the prices that must be paid rise to such an extent that these goods can no longer be sold at the desired retail price, the retailer will often have the design changed, or have a lower quality of materials used, rather than raise the retail price. Conversely lower buying prices may cause him to adopt

[6] The increasing importance of the sales tax has reduced the usefulness of "even money" pricing.

improved designs and use better materials. Only drastic changes in buying prices will result in changes in such price lines. An example of such a forced change of price lines is the experience of the variety chains. Under the pressure of rising costs they gradually abandoned first the 10-cent and later the 25-cent price limit and now generally have no strict price limits.

Fixed price lines are not quite so common in wholesaling, although they frequently occur where the wholesaler supplies goods which are sold to the final consumer at fixed price lines, or with certain limited-line wholesalers. However, even where the retail lines are rigid, the wholesale prices of the products may and often do vary somewhat without breaking up the stability of the retail price lines.

The price and output policies of manufacturers frequently must conform to the existence of more or less definite price lines at which the purchaser expects to resell such products. Under these conditions the problem is to determine in what price lines to compete and how much quality must be offered in order to sell an adequate volume. Such price ranges are found in the market for many consumer durable goods such as mechanical refrigerators, vacuum cleaners, radio and television sets, and automobiles. In the latter industry, for example, fairly definite price ranges for passenger cars have prevailed for a number of years, shifting up and down with trends in costs. The manufacturers must decide in what price ranges they will compete and then decide the quality of product to offer in each. Prices of competing cars in each range are not identical, but they do commonly fall within the range.

On the other hand, price lines are not necessarily rigid barriers to the movement of particular brands up or down. For example, in the middle fifties Buick, which traditionally had sold in the middle and upper bracket lines, for a time successfully invaded the lower-priced field.[7] From the other direction, the traditional low-priced cars, Chevrolet, Ford, and Plymouth, by adding higher-priced models and loading them with optional equipment, traded up into the medium-priced lines so successfully as to squeeze severely the brands of cars which had traditionally dominated that market.[8] At the same time by continually upgrading their "low-priced" cars, American manufacturers left a vacuum at the lowest level of prices into which foreign cars moved very successfully. The introduction of the so-called "compact" cars represented an effort by American firms to recapture this part of the automobile market.

In some other fields price lines which the manufacturer must meet are more precise, for example, in the wholesale and retail prices of certain cotton

[7] Walter Williams, "A Theory of the Declining Buick," *Current Economic Comment*, November 1959, pp. 43–50.

[8] "The Edsel Dies, and Ford Regroups Survivors," *Business Week*, November 28, 1959, pp. 26–8.

yard goods, in wholesale prices for women's dresses, and in retail prices for chewing gum and soft drinks. Sellers of women's dresses do not compete primarily on a price basis, but on the basis of style, quality of materials, and workmanship. If estimates of the cost of a proposed model indicate that it falls between two price lines the producer seldom attempts to sell at an in-between price. He either tries to sell it at the next higher price, or if that seems impossible he improves the quality so that it will, or reduces the cost in order to sell at the lower price. Resale buyers of such products likewise take the price lines for granted. In deciding what products to purchase they look at the nature of the product offered in each line, at whether it has an established good will with consumers, and at its pulling power in the market.

Suggested Prices

Retailers, and to a lesser extent, wholesalers, may not attempt at all to determine by themselves the price of some of the goods they sell. Instead they may accept the suggestion of someone else as to the most appropriate price. In the sale of many branded and advertised products, the resale price for both wholesaler and retailer is suggested by the manufacturer. Thus the manufacturer may print a retail price on the article or its container; or through his list price, his advertising, or his salesmen, he may directly or indirectly suggest a suitable price to the wholesaler or retailer. Likewise retailers, especially small retailers, frequently take a wholesaler's suggested price. In fact the price lists of wholesalers often show not only cost to the retailer but also a recommended retail price, based on standard retail markups.

So long as the retailer, or wholesaler, abides by such suggestions he is, of course, unable to influence sales through any change in prices. Thus the manufacturer or wholesaler who sets the resale price has taken over the function of retail price determination.[9] There are advantages and disadvantages to the acceptance of suggested resale prices. General conditions affecting prices are likely to be better understood by the manufacturer or wholesaler since they are in a position to study the wider market influences. On the other hand, local conditions of demand will not always be known and may induce independent price setting by the individual wholesaler or retailer.

Manufacturers also sometimes accept suggested prices. Their trade associations often collect and publish price information, or prescribe standard cost accounting methods which they hope will lead their members to charge particular prices.

[9] When manufacturers undertake to maintain resale prices under the fair trade laws they go beyond mere suggestion and insist that prices shall be maintained.

Price Leadership

Many firms determine some or all of their prices from the prices which competitors are charging. A single firm often takes the initiative and others follow—marking their prices at, above, or below the competing price, according to their general policy. The goods thus priced may be identical with those offered by the price leader, or there may be more or less product differentiation. The greater the differentiation the more such prices are likely to vary. Following a price leader may be a conscious process, or it may result indirectly from the follower's endeavor to meet competing prices on a basis which experience has shown to be wise.

For example, some retail firms sense fundamental market conditions more quickly than do their competitors and come to set the pace. It is fairly common for middle class and cheaper department stores to follow rather closely the prices offered in the basement stores of the higher class department stores. On the other hand, sometimes the management of the cheaper store may be more sensitive and higher class stores will follow him. These price relationships are often kept in line through "shoppers," who are sent out from stores to compare the prices and quality of merchandise offered in competing stores, and also as a result of the reactions of consumers who have been shopping in competing stores.

Following of competitors' prices may go so far as to constitute part of a publicized policy of a store or type of store. The classic case of "price followership" in retailing is the R. H. Macy department store in New York which for many years has followed a publicly announced policy claiming that it prices "to save our customers at least 6 per cent for cash" compared with stores providing credit.[10] To back up this policy Macy's maintains a program of continuing shopping of competitive stores to check on their current prices.[11] The well-publicized policy of the discount houses of selling below list price, and at least by implication below the price of "regular" dealers, is a recent example of pricing in part according to competitors' prices.

Price leadership is also very common in manufacturing. Among price leaders at various times in important industries have been the American Brass Company, the American Smelting and Refining Company, and General Motors Company. The price leader is usually the largest firm in the industry, or if there are two or more dominant concerns one may serve as leader as a

[10] This gave rise to the famous counter-slogan of Gimbel's department store that "Nobody, but nobody, undersells Gimbel's."

[11] There are a few explicit exceptions to the 6 per cent policy.

matter of custom, or more than one may lead in separate territories, or in turn. The smaller firms may follow because of fear of reprisal for price cutting, because of satisfactory profits under the leader's "umbrella," or simply because following his prices is convenient.[12]

It is not necessarily the case that the true price leader is the first to announce a price change, but his decision will be the decisive one in determining whether the new price will hold. Two recent and somewhat different examples will illustrate the point. In June 1958, Alan Wood Steel Company announced an increase of $6.00 a ton effective in July. United States Steel did not follow and the increase had to be withdrawn. In July, Armco and Republic Steel companies announced price increases of $4.50 effective in August. U.S. Steel followed and this price increase held. Again in 1957 Ford was the first manufacturer to announce prices on its new models. Prices were raised an average of 2.9 per cent. Shortly thereafter Chevrolet's prices were announced at an average rise of 6.1 per cent. Ford withdrew its original prices and issued new prices further raised to bring them directly in line with the higher Chevrolet prices.[13]

Price Understandings

Another method of determining prices is to set them in consultation directly or indirectly with other firms. Collusion, of course, is illegal in interstate commerce under the antitrust laws, and price understandings are more often indirectly arrived at, although occasionally cases of direct understandings are uncovered.

Trade association activities sometimes result in direct or indirect price understandings. For example, through standardized cost accounting methods the association may be able to reduce price cutting by urging the use of average costs including profits as the regular selling price. Occasionally associations have operated as so-called "open-price" associations by having members report their prices to the association and then disseminating this information to members. In such cases there is a tendency for members to get in line, even without any recognized price leader. Again many associations have fair trade

[12] Numerous examples of price leadership in different industries may be found in the two-volume work by S. N. Whitney, *Antitrust Policies* (New York: Twentieth Century Fund, 1958). An interesting account of price leadership in the steel industry is in *Administered Prices—Steel,* Report of the Committee on the Judiciary, Subcommittee on Antitrust and Monopoly (Washington, D.C.: U.S. Government Printing Office, 1958), Chap. 6.

[13] John M. Blair, "Administered Prices: A Phenomenon in Search of a Theory," *American Economic Review, Papers and Proceedings,* May 1959, pp. 445–6.

practice charters or codes of ethical competitive conduct. These sometimes have classed price cutting as an unethical activity.

Price understandings may also result from the use of patent pools and various systems of cross-licensing. By strengthening monopolistic controls they make it easier for firms to come to direct or indirect understandings about the level of prices.

Price understandings are frequently found in the local pricing of staple products which are not branded, such as coal, sugar, and lumber. Since there is little variation in the quality of generally recognized grades of such products, it is evident that the consumer can shop for them and buy them in the store which charges the lowest price. If this leads to what merchants regard as "excessive" competition they may consult with one another to determine a common price or normal markup.

Negotiated Prices and the One-Price Policy

Historically negotiated or varying prices have been the most common. This involves establishing the price to be paid each time a sale is made, with the final result depending upon bargaining, favoritism, or other similar factors. Before the passage of the Robinson-Patman Act this was very common in manufacturing and wholesaling but is less frequently used now. It is perhaps most used at present in establishing the price for products made to fill a definite order based on definite specifications, such as buildings, special machines, or printing jobs. At the retail level negotiated prices have gradually given way to a one-price policy in this country, although in less economically advanced countries this is less true. The advantages of the one-price policy in retailing are considerable: selling costs are reduced since salesmen do not spend time in price bargaining; by shifting the emphasis from price, salesmen can emphasize various nonprice aspects such as quality or service; good will is not lost through one buyer's finding that another paid a lower price for the same product.

One important area of bargaining at the retail level remains in the case of those goods for which the value of the trade-in is an important part of the final terms of sale, as for example automobiles, washing machines, or television sets. Thus, in buying an automobile, variation in the trade-in amounts to varying the price of one car in competitive bidding with retailers selling other cars. Again the prices allowed on old cars which may be equally good often vary with the bargaining power of the customers of a given retailer and hence result in different prices for the same car.

DISCOUNTS AND OTHER CONCESSIONS

The discussion to this point has centered largely about the establishment of a single price for a single type of product of a given quality. This has made the price-making problem seem much simpler than it really is for many vendors, and particularly for many manufacturers. The manufacturer of an automobile tire, for example, normally sells a given size and grade of tire to several different types of buyers. He may have to determine a different price for each class of buyer, as well as arrange different prices for each class under different conditions of sale. He may, for example, sell to automobile manufacturers, to owners of fleets of trucks, to governmental agencies, to wholesale tire dealers, to retailers, to chain tire dealers, to oil companies for resale through their service stations, to mail order houses, and to department stores. He may also sell to consumers through his own retail tire stores as well as to his own employees at the plant. For each class of customer he may have two or more prices which vary with the volume purchased. Discounts may be allowed for cash, and other conditions may cause variations in the prices charged to some or all of his customers.

Definite prices are sometimes determined for each class of trade, but in most lines of business prices are varied by giving discounts or other concessions which are figured from a base price. This base price is commonly called the "list price." The precise meaning of the term "list price" is rather indefinite and varies from industry to industry as well as from time to time. It may be a price printed in a catalog, or on other lists of the goods a vendor has for sale, from which trade and quantity discounts are deducted. For products designed for sale to final consumers through retail stores, the list price may be the price at which retailers are expected to sell and at which they usually do sell. It may, however, be a price so high that few if any retailers attempt to use it, or it may be a price above which some retailers sell and below which others sell. But whatever a list price may be or may mean for a given manufacturer or whether he has what he calls a list price at all, discounts are made from some base price, and for convenience that price will be called the "list price."

The retail prices at which goods are quoted are usually the prices at any particular time which consumers must pay for products to the one who quotes the prices. This is because the one-price policy prevails generally in retailing, and bargaining between final consumers and retailers is seldom found in the United States except for those products for which the trade-in value is important. But discounts from quoted or list prices are the almost universal

practice in the wholesale trade, particularly in the sale of manufactured products, whether sales are made to middlemen or to other types of buyers—such as manufacturers, governmental agencies, public utilities, or institutions. Bargaining over offered prices is also common in the wholesale trade. It is evident, therefore, that the prices quoted in catalogs, advertisements, and market reports are not necessarily the actual prices paid by individual buyers or classes of buyers.

Many types of discounts are found, but most of them are modifications of a few basic types. Fundamentally the various types have in common the idea that the discounts represent, at least implicitly, an effort to take into account the variations in the cost of handling different products for different classes of buyers. However, the element of bargaining often involved in the various types of price concessions has frequently resulted in differences in price to different customers for the same product which were not related to cost differences, and which in effect represented price discrimination between customers. It is probably true that since the passage of the Robinson-Patman Act in 1936 the degree of price discrimination present in the various systems has materially lessened due to the prohibitions on price discrimination in the Act. The provisions of the Act and some indications of its effects on discounts will be considered in Chapter 28 after the various forms of discounts have been described.

Trade Discounts

Trade discounts are those discounts from list prices which are granted to a specific class of buyers, such as other manufacturers, wholesale middlemen, or retailers. Assume, for example, that a manufacturer believes that $1 represents a fair retail price for one unit of his product. He will quote a price of $12 per dozen as the list price. But if he sells to regular wholesalers, he must make a price which will enable the wholesaler to sell to retailers at such a price that they, in turn, can sell to consumers for $1. To make this possible he grants trade discounts of, say 33⅓ per cent and 15 per cent from the list price. This means that the wholesaler pays $12 less 33⅓ per cent ($4) less 15 per cent of $8 ($1.20), or $6.80 for one dozen items. In selling to the retailer the wholesaler retains the 15 per cent discount as a margin to cover his expenses and profit, and quotes $12 less 33⅓ per cent or $8 to the retailer. This leaves the retailer a margin of one third of his selling price to cover his expenses and profit.

More than one trade discount may be given to a particular middleman. Thus, in the previous illustration, two discounts were given to the wholesaler.

More than two are common. In the illustration, the manufacturer could increase the number of discounts from his list price. He could, for example, quote large jobbers, wholesalers, or chain stores $12, less 33⅓, less 15, less 10, less 5. Such a scheme is known as a chain of discounts. This makes it easy for the seller to vary his offers from the same list price, since he can vary prices among buyers by varying the discounts given.[14] Moreover, price changes are facilitated, since, instead of changing all prices—which would be a difficult task where catalogs or price lists are issued—a discount is varied inversely to the change in prices. Thus, if prices advance, discounts are lowered, and if they decline, discounts are increased. These changes may be made by actual changes in a given discount or by adding to or subtracting from a chain of discounts.

The example used above illustrates a very simple discount plan. Many manufacturers who sell consumer goods have a discount policy which results in different prices to small retailers, department stores, chain stores, and wholesalers. And they may offer quantity discounts, cash discounts, and various types of concessions which, in turn, may also vary with types of customers. In addition to the regularly established discounts, special deals are sometimes made with individual customers. Manufacturers of industrial goods, likewise, often group customers into a number of classes with different discounts for each class and utilize other forms of discounts.

Quantity Discounts

Quantity discounts are based directly upon the quantity purchased, either at one time or over a designated period. It is often difficult to distinguish between quantity discounts and trade discounts, for both types are frequently granted to one customer, and it is sometimes impossible to determine where one ends and the other begins. In the case of the trade discount cited above, for example, the manufacturer could add an extra discount to obtain a large order from a particular buyer, or to obtain orders from a particular class of buyers. He could also adopt a general policy of adding a discount for all purchases above a certain amount, or he could vary his quantity discounts for each class of customers. The discount allowed when a large quantity is purchased is commonly justified on the presumption that large orders can be sold or delivered more economically than small ones, or that large orders can be produced more cheaply. The amount of the discount, if this presumption is correct, should approximate the actual savings that result from the

[14] Each succeeding discount is figured from the amount left after the preceding discount is subtracted.

size of the order. In practice, there may be little correspondence between the two. In the first place, the amount of the saving may not be known; and if it is known, it serves only as a limit to the amount of the discount. In the second place, quantity discounts have sometimes been given to "get the business"; that is, they are a sales device, a part of the cost of selling, and may not be given simply because large orders can be more economically sold, delivered, or produced.

Discounts based upon the quantity purchased over a period of time, sometimes called cumulative quantity discounts, are also used. They serve as rewards or inducements for the continued patronage of the buyer, rather than because any savings are effected which can be directly traced to the amount purchased.[15] Discounts given upon this basis are sometimes referred to as "patronage" discounts. Some firms base the discounts given in one year upon the quantity purchased during the previous year. Others grant rebates at the end of the year in proportion to the quantity bought during the previous twelve months. The latter are often called "deferred" discounts, or rebates. Quantity discounts are not confined to wholesale trade. For example, food stores commonly sell bakery goods at a lower unit price when sold by the dozen. Canned foods may be 9 cents each or three for a quarter. Gas station discounts on gasoline sold to regular customers occur in some areas (and may be a prelude to a more general "price war").

Cash Discounts

Cash discounts are deductions from the amount of a bill for payment in full within a specified time. The period stipulated is relatively short, commonly ten days, although there are wide differences in different industries and between different commodities. Since cash discounts were discussed in connection with market finance in Chapter 22, no further reference will be made to them at this point.

Promotional Discounts

Promotional discounts are a reduction in price given to the buyer as a payment for some form of direct sales promotion helpful to the seller. Thus a manufacturer, or sometimes a wholesaler, will grant an allowance to a retailer for including in his newspaper advertising the product of the manu-

[15] This inducement to continued buying may, of course, make continued sales easier to make and selling less expensive, although the actual amount of the saving is seldom related to the discount, if indeed it can be determined at all.

facturer. Similar allowances may be made for including promotion of the product in television or radio advertising of the retailer or for giving the product special prominence in window or counter displays. Promotional discounts are also used to reimburse retailers for the costs involved in the use of demonstrators for the manufacturer's product or to induce the retailer's salesmen to put special selling effort behind the product. These latter devices are particularly likely to be used by a company introducing a new product.

True promotional discounts are not intended as a price concession but instead are a direct payment for a service to the manufacturer or wholesaler. As such they should bear a direct relation to the cost or value of the service to the manufacturer. Sometimes, however, discounts have been granted to buyers which were called promotional discounts but for which in practice little or no promotional service was received. These amount to little more than a price concession and cannot properly be called promotional discounts. There may also be some discrimination involved in the granting of promotional discounts if they are not available on a proportional basis to all buyers.

Secret or Confidential Discounts

Secret or confidential discounts—also referred to as "inside" discounts—are sometimes given to preferred customers in order to obtain or retain their patronage. Such discounts may be in the form of rebates granted under conditions similar to those described above in connection with quantity discounts, or they may be special concessions determined as a result of bargaining with individual customers. In this connection it may be pointed out that discounts may be cross-classified as to whether they are published, secret, or the result of bargaining. In the case of the first, all customers of the firm, or all customers of a given class to whom the discounts apply, that is, all retailers, or all wholesalers, or all manufacturers, are familiar with the size of the discounts and the conditions under which they are given. The amount of a secret discount is known only to the two parties to the transaction; and the size of the bargaining discount depends upon the bargaining ability of the purchaser and the seller. It may or may not be secret.[16]

[16] It is because of the existence of secret and bargaining discounts that the actual prices paid for many products of a given type are frequently below the prices publicly quoted in newspapers, journals, and in price figures wherever found. This is particularly true in highly competitive lines and especially in times of depression. The wide extent of these variations from quoted prices was first brought to the attention of the general public and of many interested parties through the chain store investigation conducted by the Federal Trade Commission in the early thirties, the hearings that preceded the passage of the Robinson-Patman Act, and more recently in the cases brought before the Federal Trade Commission under that Act.

Other Concessions

Prices and pricing are affected by other factors which do not change the quoted price as modified by different types of discounts. Concessions are frequently made which make a particular offer more valuable but which it may or may not be possible to evaluate in precise monetary terms. Payments may or may not be required on the day they are due; the bill may be "postdated," so that actual payment can be made a longer time after the receipt of the goods than seems to be indicated on the face of the bill; large firms sometimes "take" larger cash discounts than those nominally allowed; prices may be guaranteed against price decline; goods may be delivered without charge in certain areas, or to certain customers, or to all customers; repairs and adjustments may be made free of charge or at less than cost; there may be zone prices and basing point prices; free advertising materials may be supplied; local advertising of middlemen may be paid for; and "free deals" may be granted for purchases of a certain quantity.

These discounts and concessions are seldom used in selling to the final consumer and in selling raw materials, but they are common in many fields of business, and particularly in the sale of manufactured commodities. Such concessions seem to be a natural outgrowth of competition for business and are modern examples of primitive "higgling" in the market. They add to the difficulty of pricing and to the difficulty of buying. Until recently they have been rather generally accepted as normal to business operations, but in recent years many of their manifestations have come more and more to be looked upon as unfair or unwise.

GEOGRAPHICAL PRICING SYSTEMS

The geographical location of sellers in relation to buyers can have a significant influence on pricing policies. For many products differences in the distance of buyers from a seller will result in significant difference in the transportation cost of delivering goods to buyers. Sellers must include in their pricing policies some way to handle these differences in transportation costs. There are five major ways in which this is done.

F.O.B. Factory or Warehouse

Perhaps the simplest method of handling differences in transportation costs to different buyers is, in effect, for the seller to do nothing about them.

When prices are quoted f.o.b. (free on board) factory it means that the seller agrees to deliver the goods to the transportation agency. From there on, the buyer must take responsibility for the goods including the payment of the transportation charges. This means that buyers will pay identical prices to the factory or wholesaler, but that the actual cost of the goods to different buyers will vary by the difference in transportation charges.[17]

The difficulty which often arises for a seller under an f.o.b. system is that his market will tend to be limited by the area within which the freight charge to customers is less than the freight charge to the same customers from competing sellers. Thus if there are competing sellers in Chicago and Detroit and transportation charges are a significant item, the firm in Chicago will be unable to sell to a buyer in Detroit, assuming the f.o.b. prices are the same.

The remaining four pricing policies are intended to meet this difficulty. While the details differ they all involve in one way or another the inclusion of delivery of the goods in the price quoted to the buyer. For this reason they are generally designated as delivered pricing systems. These systems, then, make it possible for sellers at different distances from buyers to quote similar prices at any given location.

Freight Equalization

One way to meet the difficulty is to equalize freight, i.e., to quote a price which is made up of the f.o.b. price plus the cost of delivery from the competitor closest to the prospective buyer. In this way the firm in Chicago, referred to above, will be able to compete with the Detroit firm since the price to the customer will be the Chicago f.o.b. price plus transportation charges from the Detroit competitor. Such a practice will mean that the realized return at the factory or warehouse will be less on distant than on nearby sales. Nevertheless, the practice will be profitable so long as capacity is available and the net after transportation costs exceeds variable costs.

Freight Allowed

Under this system of delivered pricing no separate item is included for transportation. Instead the seller quotes a price which includes delivery at the customer's location regardless of distance. This method of pricing is common for well-known branded consumer goods of small bulk and relatively high

[17] It is interesting to note that a cash-and-carry retailer is also in fact selling on an f.o.b. basis.

value, for example, candies, cigarettes, and soft drinks which may sell for the same price over the entire country. The Post Office Department uses the same system for pricing the delivery of several classes of mail—in fact the system is sometimes called "postage stamp pricing."

This method of pricing has several advantages for many sellers. It permits advertising of a single price throughout an entire market area. The quoting of prices is simplified; yet the seller can reach customers located near competitors as well as those nearby. Resentment of more distant customers against the lower prices obtained by nearby customers under certain other pricing systems may also be eliminated. Moreover, since the amount of the delivery charge is small, the cost may be more than made up by the saving in trouble and accounting costs which results from selling to all buyers at an equalized price, other than charging for delivery separately.

Zone Pricing

Sellers of products for which the cost of transportation is high in relation to price may find a freight allowed system impracticable. Under these conditions a system of pricing which yields some of the advantages of a freight allowed procedure, but also takes account of variations in delivery costs is called "zone pricing." This means that the marketing area for the product is divided into two or more geographic zones. Prices from zone to zone tend to vary according to transportation costs, but within each zone a uniform delivered price is charged. The system has been most common with industrial sellers of bulky goods such as many building products, food products, paper, and electrical machinery. It is sometimes used with consumer goods also, for example, the common footnote in the advertisements of nationally sold consumer durable goods, "Prices slightly higher on the West Coast."

Basing Point Pricing

The last method of geographical pricing to be considered is the basing point system. This system has attracted the most attention and has had perhaps the most widespread effects of any of the geographical pricing procedures. It will, therefore, be worthwhile to consider this pricing practice at greater length.

Characteristics of the System. The basing point system has appeared only in industries having rather definite characteristics. The most important of these are: the product is highly standardized, so that there is little reason to prefer one producer's product over another; the product is bulky so that

transportation costs are relatively high; the market for the commodity is wide and the producers are widely scattered; the product is produced under conditions of heavy overhead cost, with price cutting likely when output is low; the number of producers is small. Some of the important industries in which the system has been used at various times illustrate these conditions. These include, for example, iron and steel and other metal products, cement, lumber, clay products, plate glass, bricks, stone, sugar, and flour.

Under the basing point system, goods are sold by all firms at delivered prices calculated by adding to the price at the basing point the transportation costs from the basing point to the place of delivery, regardless of where the goods were manufactured. For example, at one time the steel industry used Pittsburgh as the sole basing point in what was called the "Pittsburgh plus" system. This meant that a steel consumer in Chicago buying from a steel company in the Chicago area, nevertheless paid a price which was the Pittsburgh price for that product plus the cost of delivering the steel from Pittsburgh to Chicago. It made no difference that the steel was produced and delivered to him from the Chicago area. On the other hand, if the Chicago steel firm wished to sell to a customer near Pittsburgh, his price would still be the Pittsburgh price plus freight from Pittsburgh to the customer. In this case the Chicago mill would have to absorb the freight cost. Under such a system it is clear that the price at every geographical point is uniform to buyers, regardless of where the seller's plant may be located.

When more than one point is used as a basing point, the system is called a multiple basing point system. In this case each basing point governs the price in its own area. Inter-area shipments may occur, but when a shipper goes outside his territory he charges a price based upon the basing point for the other territory. Thus prices still remain uniform at each geographical point.

Appraisal of the System. Proponents of basing point pricing have used several arguments to show its desirability.[18] Perhaps the major line of argument favoring the system has been that in the absence of stable prices there would be great variations in price over the business cycle—very high during prosperous phases as demand pressed upon capacity, and ruinously low in depression because of price cutting which reached down toward variable costs as producers tried to meet at least a part of the heavy overhead costs. This in turn would mean a tendency toward bankruptcy and greater concentration in the industry with lower capacity and poorer service. In the absence of ex-

[18] For detailed discussions of the arguments for and against basing point pricing see Fritz Machlup, *The Basing Point System* (Philadelphia: Blakiston, 1949), esp. Chap. 4; and Walter Adams (ed.), *The Structure of American Industry*, 3rd ed. (New York: Macmillan, 1961), pp. 160–71.

perience, it is perhaps difficult to know whether the results of competition would be so drastic, and in any case there are intermediate positions.[19]

It is also argued sometimes from the opposite point of view that identical pricing is evidence of the presence of competition, since with identical products different prices would be impossible. While different prices no doubt would be impossible in the short run, the lack of correspondence of industry conditions even approximating those of pure competition, the specific pricing formulas which produce the uniformity, and the lack of the results ordinarily expected from competition in terms of flexible prices and the survival of efficient producers, effectively dispose of the argument.

Criticisms of the basing point method center in considerable part on the argument that competition is shifted from pricing to wasteful use of transportation facilities, multiplication of selling effort, and duplication of selling services. Waste of transportation facilities results in what is usually termed "cross-hauling."[20] Since customers can obtain no price advantage by purchasing from the nearest seller they may well purchase from a more distant seller. For example, under the old Pittsburgh plus system a steel consumer in Chicago might just as well buy in Pittsburgh as in Chicago, thus bringing about a waste of railroad transportation.

Similarly, since sellers cannot gain sales by price cutting, competition for business must center in selling practices and the provision of services. While some of this may be of value to the buyer, there is likely to result much wasteful and duplicative effort.

Another important consequence of the system is that it brings about price discrimination among the customers of nonbasing point mills. This may seem surprising at first glance since all customers at any geographical point pay the same price. Discrimination arises in the sense that the price to customers at different geographical locations is not based directly on cost. Producers with plants close to delivery points charge the customer for freight which the producers do not have to pay—so-called "phantom freight." Producers with plants far from the delivery point may have to absorb freight charges—so-called "freight absorption." Thus a nonbasing point seller will receive a different "mill-net" on sales to customers at different points with the discrimination being against the buyer whose purchases allow the larger mill-net.

In one important respect the system may also make it more difficult for new firms to establish themselves in the industry. This is because any-

[19] See the discussion of the effects of antitrust policy on basing point pricing in Chap. 28.

[20] The term "cross-hauling" is sometimes confined to the case of identical goods passing one another on the way to their destination, but it is evident that the wastefulness is broader than this.

where within the basing point territory the new firm is expected to charge the same price as the old established firms. Thus the new firm cannot establish itself by means of a price appeal and must find other means for attracting customers.

Finally, it has been held by many economists that the existence of a basing point system means a monopolistic arrangement among the firms involved, either through price agreements or else through tacit or explicit agreement to follow a price leader. This means both higher prices to customers and, usually, a more rigid price structure.

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See also references at the end of Chapter 28.

28. PRICE POLICIES AND GOVERNMENTAL INFLUENCES

There are several areas of price policy into which the law has entered very directly. These include: discounts and other concessions and delivered price systems with the Clayton Act and the Robinson-Patman Act; resale price maintenance with the so-called state "fair trade" laws and the federal Miller-Tydings Act and McGuire Act; and loss-leader selling with the state loss-limitation laws. These areas of price policy where legal aspects are especially important will now be considered.[1]

LEGAL ASPECTS OF DISCOUNTS AND VARIATIONS IN DELIVERY TERMS

Particularly since the passage of the Robinson-Patman Act in 1936 as an amendment to the Clayton Act, the price discrimination aspects of discount systems and delivered price systems have been called into question by the Federal Trade Commission, resulting in important changes in these price policies.

The Clayton Act

The Clayton Anti-Trust Act of 1914 made it illegal, among other things, for a seller to discriminate in price between buyers of commodities when the effect was "to substantially lessen competition or tend to create a monopoly in any line of commerce." Exceptions were made when differences in price were based on differences in the grade, quality, or quantity sold, made only due allowances for differences in costs of selling or transportation, or were

[1] Other aspects of the state in relation to marketing are treated in Chaps. 29 and 30.

made in good faith to meet competition in the same or different communities. This made it legal to allow some quantity discounts and to vary prices to meet competition in good faith. While the Federal Trade Commission held that price differences were legal only when they could be justified by differences in cost of the types mentioned in the Act, the court ultimately held that price discrimination must injure sellers rather than buyers to be illegal.[2] The difficulty of proving a lessening of competition or a tendency to create a monopoly to the satisfaction of the courts also made it impossible to prevent many instances of price discrimination.

During the period just preceding the enactment of the Robinson-Patman Act there had been a growing sentiment in favor of the protection of small merchants against their larger competitors. It was commonly believed that independent retailers and wholesalers had lost business to the chains and other large retailers because the latter could buy at lower prices than the independents, and because certain services, such as advertising allowances, were granted more freely to them. It was quite generally believed that quantity purchases were used by large buyers as a lever to obtain price and advertising concessions that could not be justified by any saving in the cost of serving them. The report of the Federal Trade Commission on its investigation of chain stores confirmed to a considerable degree this impression, showing that the price and advertising concessions enjoyed by the chains had been among the reasons for their lower prices. The Commission also pointed out that it was difficult to prohibit what it considered to be unjustifiable discrimination with the powers granted to it under the original Clayton Act.[3] All of these were important reasons for the passage of the Robinson-Patman Act.[4]

The Robinson-Patman Act

Effects on Discounts and Other Concessions. The Robinson-Patman Act, which is primarily an amendment to Section 2 of the Clayton Anti-Trust Act, became law on June 19, 1936. The major objectives of the Act were:

[2] In *Van Camp and Sons Co.* v. *American Can Company*, 278 U.S. 245 (1929), the Supreme Court decided, however, that selling cans to one food packer at lower prices than those charged to others tended to create a monopoly in that industry.

[3] See Federal Trade Commission, *Final Report on the Chain-Store Investigation*, Senate Document No. 4, 74th Cong., 1st Sess., 1935, pp. 64–5.

[4] Over half of the states have laws designed to prohibit price differences in sales of articles of like grade and quality where these differences injure competition or promote monopoly, unless the differences can be justified by differences in quantity purchased, or the cost of manufacture, delivery, or selling, but with the right to meet competition and usually some other exceptions. For details of each state law see *Manual of Commercial Laws*, National Association of Credit Men, published annually.

1. To make price discrimination between purchasers of "commodities of like grade and quality" illegal when it injures competition, except where justified by cost differences or certain special market circumstances enumerated in the Act.

2. To prevent the direct or indirect payment of brokerage fees to the purchaser.

3. To prohibit the use of advertising allowances and similar payments for services rendered by the buyer, or the furnishing of services to customers unless such payments or services are available to other customers on "proportionally equal terms."

In implementing the Act, Congress also placed on the person charged with violating the Act the burden of proving that any price or service differential is not illegal, and made not only the seller liable to the terms of the Act but also made it unlawful for the buyer knowingly to induce or receive an unlawful discrimination in price (except in the case of advertising allowances or services).

While the Act is not very clearly written, the changes have strengthened the law.[5] Whereas discrimination under the original Clayton Act was declared illegal when the effect was "to substantially lessen competition or tend to create a monopoly in any line of commerce," the Robinson-Patman Act revision adds to that phrase "or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with the customers of either of them." This implies that there are undesirable practices which injure competition as well as those which lessen it or tend toward monopoly. By relieving the Commission of the necessity of proving a *substantial* lessening of competition or a tendency to create monopoly in order to prevent undesirable practices, the scope of its activities has been considerably increased. And by adding "with the customers of either of them" the Act is extended beyond the injury of *direct* competitors. The inclusion of customers of those who grant or receive price discriminations within the scope of the Act is important, because a major object of the law is to prevent large buyers from receiving advantages not accorded to small buyers.

Effect of the Prohibition on Price Discrimination. Perhaps the broadest effect on price policies has resulted from the prohibition of price discrimination. With some exceptions, different prices to different customers are legal

[5] Indeed, Edwards has stressed "The haphazard way the bill was developed." Corwin D. Edwards, *The Price Discrimination Law* (Washington, D.C.: Brookings Institution, 1959), p. 28. The most complete compendium of Robinson-Patman law and its effect is contained in this volume.

only when they represent "due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered." This is of chief interest in the use of quantity discounts, and the proof must rest primarily on costs. Very large differences may be easy to show, but to prove differences in cost, particularly in selling costs, is often very difficult. Most businessmen have no accurate information on the cost of selling individual items. Accounting methods for determining marketing costs are not highly developed and pose very difficult problems to the cost accountant.[6] A large proportion of such costs are indirect and must be arbitrarily applied to individual products and individual transactions. Even if a businessman could prove differences in cost to his own satisfaction, he might not be able to prove them to the satisfaction of the Commission or of the courts.

Exceptions stated in the Act include price discriminations made in response to changing conditions in the market, such as "actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned", and sales made "in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor."[7] The seller may also select his own customers "in bona fide transactions and not in restraint of trade." The effect of this last phrase is to make it possible to discontinue selling or to refuse to sell certain classes of trade, such as consumers or small independent retailers, if the seller feels that the higher prices he must charge them or the discrimination in service he wishes to accord to other purchasers, cannot be justified before the Commission. The seller may also try to show that his operations are not subject to the Act because the discrimination is really a difference in the price of different articles, that is, that they are not of "like grade and quality," or because customers are not in competition. Thus the basic situation at present with regard to quantity discounts is that discounts offered by a seller must be based on savings in cost, with certain specified exceptions the most important of which is that of a discount made in good faith to meet the price of a competitor.

There is also one interesting exception to the rule that quantity discounts based on costs are legal. The Act permits the Federal Trade Commission to establish maximum quantity limits for a seller beyond which no further quantity discounts may be granted if there are so few buyers in very large

[6] A significant side result of the Robinson-Patman Act has been the stimulation of considerable interest in cost accounting for marketing.

[7] A 1951 decision made "good faith meeting of competition" a complete defense against charges of price discrimination. *Federal Trade Commission* v. *Standard Oil Company (Indiana)*, 340 U.S. 231.

classifications that the discounts would be unjustly discriminatory or promotive of monopoly. The quantity limit rule has been used sparingly so far, and its application has not been completely clarified by the courts, but the rule may have significant implications in the future if more active use is made of it by the Federal Trade Commission in future proceedings.[8]

Effect of the Prohibition on Payment of Brokerage Fees to Purchasers. The law definitely prohibits the payment or receipt of brokerage and similar payments, "or any allowance or discount in lieu thereof," except for services rendered in the sale or purchase of goods, and then only if the broker acts as a *bona fide* third party. Such payments cannot be made to "the other party in a transaction." In other words a buyer may not be allowed any brokerage fee if he buys directly or if he controls the buying organization that performs the brokerage operation. Neither can such fees be paid to a supposedly independent broker who represents buyers and rebates a part of his fee to them. Even though it may be shown that the seller's costs are reduced by an amount which justifies the payment, any such allowance or payment is illegal if brokerage costs must be paid by other buyers. This clearly tends to prevent quantity buyers from benefiting from any saving in costs to the seller which may result from dealing directly with him. There is no doubt that allowances for brokerage have been used to give unduly low prices which could not be justified by the savings in cost. But neither can their complete elimination be justified except as a device to prevent large buyers and final consumers from receiving the benefits of their operations.

Effect of the Prohibition on Discrimination in Advertising Allowances and Services. Payment for advertising and other services furnished the vendor by a customer is illegal under Section 2(d) of the Act, unless the payment is available on "proportionally equal terms" to all customers competing in the distribution of such products.[9] This is to prevent the use of advertising or other "allowances" as a blind for indirect price discrimination. Similarly under Section 2(e) it is illegal to furnish "services or facilities" to any customer on terms which are not accorded to all customers on proportionately equal terms. This section was designed to prevent such practices as furnishing demonstrators and salesmen or special display cases to some customers and not to others.

It is evident that it may often be difficult to give such services on proportionately equal terms. In many instances it is probably not worthwhile for the

[8] The courts have not been too friendly to quantity limit rules. In *Federal Trade Commission*, et al., v. *B. F. Goodrich Company*, et al., 242 F (2d) 31 (CA D.C. 1957) the court struck down one of the few such rules issued by the Commission.

[9] Under this last phrase it does not appear to be necessary for the manufacturer to give proportionately equal terms to all customers, but only to those "competing." That is, a local sales promotion campaign could presumably be carried on through retailers without making it necessary to extend the privileges of that campaign to all other areas.

vendor to pay for services performed for small customers or to give any special forms of assistance to them. Moreover, it may be difficult to determine what are proportionately equal terms. For example, in the case of demonstrators, one commentator said that this means that if a sales girl is furnished to a large department store for three weeks, a corner drug store handling the same cosmetic line should have a midget for five minutes.[10] Only a small number of orders have been issued by the Commission under these sections and the meaning of "proportionally equal" is still relatively unclear. In general, the Commission seems to approve using the volume of the goods purchased from a seller as a basis on which to grant proportional allowances or services. It is also apparently permissible for the allowance to be given for advertising services from buyers not only when the services are identical—for example, proportionate expenditures on newspaper advertising—but when they are similar—for example handbills, if newspaper advertising is not feasible for some buyers.

The most serious question concerning the advisability of these sections of the law concerns the validity of its basic assumption. It appears to assume that an advertising allowance or the provision of a service to a buyer is simply another type of discount on the price of goods sold. No doubt this has often been the case. But, as Edwards has pointed out, "in some cases an advertising allowance is a payment made in good faith by somebody who wants to buy some advertising; and, in such a case, a statement that he can't buy the advertising he wants from the man who can supply it unless he is willing to buy advertising he doesn't want from all his other customers . . . interferes with the selective purchase of sales effort." [11]

Conclusions on Effects on Discounts and Other Concessions. The Act has had significant results on discounts and other concessions although the final effects are still not clear. In general, it can be said that the Act has had a definite influence toward placing price differentials on a cost basis rather than on a mere bargaining basis. This was, of course, a major objective of the law. Cumulative quantity discounts have been held to be illegal by the Commission unless a saving can be shown on individual shipments which was not allowed in the original price. The Federal Trade Commission has been unwilling to consider the contention that such discounts promote trade and so reduce selling costs, although this has undoubtedly been a major objective of many such devices. In fact, it believes manufacturers often deceive themselves in this belief, pointing out that the individual orders from some large buyers are often smaller than those of some buyers whose total purchases

[10] Corwin D. Edwards, *Problems in Price Discrimination*, Washington State University Lecture (dittoed), Pullman, Washington, March 1958, p. 8.

[11] *Ibid.* p. 8.

are far less. It has also held that prices granted to retail branches of corporate chains or to members of contract chains, which are based on the aggregate of sales rather than on the value of shipments to individual units, are not warranted when such prices are lower than those granted on sales to independent retail merchants. Trade discounts to wholesalers that are larger than those granted to retailers have not been considered illegal by the Commission, except on that part of a wholesaler's sales which is made at retail.

The effect on the current price policies of business has varied. Many businessmen are more or less ignorant of the law and have ignored it. Many others, pressed by the desire to make sales, or fearful that their large customers will go elsewhere if they change their policies, have gone ahead with policies which may be illegal. Many small businessmen, in particular, believe the Commission will attack the policies of large firms first and that it will, consequently, be a long time before their own cases are considered.

Many other businessmen have studied their price, discount, and service structures. Minor differences between customers have generally been ignored and, so far at least, the Commission has also ignored them. Obvious price discriminations have been changed or eliminated by some sellers; some discriminations in service policies have also been changed to whatever may be considered to be proportionately equal terms. These changes have doubtless been made because of a desire to obey the law. But an additional incentive has been the desire to eliminate concessions to large buyers, and the law has often served as a good excuse for the withdrawal of such concessions. Small accounts have sometimes been eliminated when the manufacturer did not wish to give the same discounts to small and large buyers. To avoid price discrimination in such cases it was simpler to eliminate small accounts rather than try to find a practicable way of including them. Advertising allowances have become fewer and smaller in size, with sellers more likely to check whether the buyers were performing the services for which the allowances were paid.

The net effect on small merchants is difficult to determine. Although large buyers who have lost favorable concessions have tried to replace them in new ways that are legal, it is clear that the net effect has been a reduction in price and service concessions to large buyers. On the other hand, it seems certain the small store owner has not received the advantages in his competition with the large dealer that were expected when the law was passed. Along with his large competitor, the retail member of a contract chain has been prevented from receiving certain price concessions.[12] Moreover, it has

[12] *Biddle Purchasing Co.* v. *Federal Trade Commission*, 96 F (2d) 687 (1938) and FTC Docket No. 3783, 1943, Affirmed CCA-7, June 13, 1945.

become more evident that the advantages which large retailers possess over their smaller competitors are seldom confined to price and service concessions, as was so commonly assumed when the law was passed. To the extent that such large firms are more efficient economically than their small competitors the Act does not appear to hinder their progress.

Effects of the Robinson-Patman Act on Basing Point Pricing. For many years the Federal Trade Commission has attempted to prevent the use of the basing point pricing system. The Commission's efforts met with little success until the passage of the Robinson-Patman Act encouraged the Commission to try to limit further the use of delivered price systems on the grounds of price discrimination. In a series of decisions beginning in 1945, the Supreme Court has accepted the contention of the Federal Trade Commission that uniform delivered prices arising under basing point pricing systems result in a net return to the seller which differs at different points because of phantom freight and freight absorption, and therefore is in effect a price discrimination between buyers at different geographical points.[13] In 1948 the attack on basing point pricing was further strengthened when the Supreme Court in the *Cement Institute* case upheld a broad interpretation of collusion under which concerted action without formal agreement is adequate to show unlawful conspiracy. Likewise, price discrimination was found in that the pricing system resulted in both phantom freight and freight absorption.[14]

These decisions have had a substantial effect on pricing in a number of industries. In the first few years after the corn products and cement cases many industries operating on a basing point system shifted to f.o.b. mill pricing with buyers paying the freight to the point of delivery. However, the Commission stated repeatedly that neither the law nor the orders in the basing point cases required f.o.b. mill pricing or prohibited freight absorption to meet competition. Moreover, as noted earlier, the Supreme Court in the *Standard Oil Company (Indiana)* case in 1951 declared that meeting competition in good faith was a complete defense against charges of price discrimination. Accordingly, for industries where transportation costs are large, the situation now appears to have developed to one where most commonly prices are quoted f.o.b. mill, but with freight absorption to competitive points a widespread practice, and with buyers often permitted to take delivery at the mill if they wish.[15]

[13] *Corn Products Refining Company* v. *Federal Trade Commission*, 324 U.S. 726 (1945), and *Federal Trade Commission* v. *A. E. Staley Manufacturing Company*, 324 U.S. 746 (1945).

[14] *Federal Trade Commission* v. *Cement Institute*, 68 S. Ct. 793 (1948).

[15] Corwin D. Edwards, *The Price Discrimination Law* (Washington, D.C.: Brookings Institution, 1959), pp. 390–400. See also Samuel M. Loescher, "Geographical Pricing Policies and the Law," *Journal of Business*, July 1954, pp. 211–24.

RESALE PRICE MAINTENANCE

Resale price maintenance is the marketing policy under which the manufacturer or owner of a commodity, identified by brand, trade-mark, copyright, or patent, places restrictions on the price at which that commodity shall be sold by purchasers and subpurchasers.[16] It is a relatively modern practice, the desire to practice price maintenance having grown out of the development of various schemes for differentiating products by brand, trade-mark, or other means. Such identification, combined with the continuous production of a satisfactory product and effective marketing, has enabled some manufacturers to build a widespread and relatively constant demand for their products.

Reasons for Price Cutting by Retailers

Success in the endeavor to differentiate a product created a new problem since many retailers soon saw in these well-known branded articles an opportunity to make a strong appeal to consumers on a price basis. This has been done primarily by large-scale retailing organizations such as chain stores, mail order houses, and some department stores. By selling well-known articles at a lower price than was customary, they could themselves realize on the good will attaching to the manufacturer's brand, and so attract trade to their stores.[17]

This has been done in varying degrees. Some stores used a few such articles as "leaders," either to give the impression that all their prices were low, or simply as a device to induce buyers to come to the store in the hope of selling them other goods at a more normal markup. They often have found it is particularly advantageous to be able to cut prices on brands for which widespread advertising by manufacturers has created a consumer demand, and on which price comparisons can readily be made by consumers. It has been one of their best means of gaining a reputation for selling at low prices. Other stores have followed a policy of selling all or a large proportion of products at prices lower than those charged by the majority of their competitors.

These large price-cutting organizations justify their low prices on the basis of the advantages they possess. Frequently their large size and financial strength enable them to take advantage of quantity and cash discounts. Their operating costs may be low because of volume of business, curtailment of

[16] Resale price maintenance is frequently called "fair trading," especially by its proponents.

[17] In many states loss-limitation laws have set lower limits to price cutting. See the subsequent discussion in this chapter.

service, and other reasons. They argue that they and their customers can gain the advantage of their low expenses and curtailed services only when they can reduce prices and pass the savings on to the consumer.

Reasons for Resale Price Maintenance by Manufacturers

As a result, many manufacturers have found that, although the identification of their products has to some extent limited direct price competition with other manufacturers of similar products, the cut-price policies of some of the middlemen to whom they sell involves them in the price competition in which their dealers engage. Those dealers who cannot meet the low prices of their competitors, or do not wish to meet them, have frequently complained to the manufacturer and asked him to prevent price cutting in the sale of his product.[18]

Perhaps most small retailers, and many large organizations who appeal primarily on a nonprice basis, favor resale price maintenance. Briefly, they want manufacturers to maintain prices in order to avoid the cut-price competition of other retailers, and many less efficient retailers hope that the maintained prices will be high enough to cover their own high costs of operation. A reduction in the price of a well-known product may greatly increase sales in the price-cutting stores. Competing retailers who will not, or cannot, or do not wish to reduce their prices fear that if they maintain the old price for the product they will lose trade to the price cutter, not only in this product but perhaps in others. If, on the other hand, retailers follow the lead of their cut-price competitors they may make little or no profit on those sales, or even sell at a loss, and in spite of their losses there may be little or no increase in their total trade in other goods. Even their sales of the particular product involved may not increase if the low price becomes common, or else the fact the low prices prevail for it may enhance its sales at the expense of other brands they prefer to sell.

It follows that many retailers favor price maintenance. Believing that price cutting is inimical to their interests, they bring pressure to bear on the manufacturer by threatening to withdraw their trade from him and to push competing products if he does not maintain prices, or by merely trying to show him that it is to his interest to protect them; or they may bring pressure to bear indirectly, by losing interest in the sale of his product.

Wholesalers have not taken so definite a part in the price maintenance

[18] For a thorough discussion of resale price maintenance, see *Report of the Federal Trade Commission on Resale Price Maintenance* (Washington, D.C.: U.S. Government Printing Office, 1945). See also E. T. Grether, *Price Control Under Fair Trade Legislation* (New York: Oxford University Press, 1939).

controversy as have retailers. Many individual wholesalers are opposed to resale price maintenance because they themselves wish to retain the privilege of cutting prices. But the average wholesaler's chief interest in the problem is determined by the effect of price cutting on his retail trade. With the constant growth of large-scale retailing establishments on the one hand, and the growth in direct selling by manufacturers on the other, wholesalers find that competition within the wholesale trade is growing more intense, and their business depends to an increasing extent on the small independent retailer. They tend, therefore, to favor price maintenance.

Alternative Policies to Handle Price Cutting

These opposing views place the manufacturer in a real dilemma as to the best price policy. In many cases the manufacturer must decide whether it is to his advantage to maintain prices and attempt to keep the smaller dealers satisfied, or to permit price cutting and thus foster the trade of the large price-cutting stores regardless of the attitude of his smaller customers. Three alternative policies are usually available. If his difficulty seems to arise from the fact that unduly large price concessions have been made to the price-cutting merchants, the manufacturer may merely decide to eliminate these concessions but not resort to price maintenance. Or, whether he allows price concessions or not, he may attempt to maintain resale prices. Finally, he may decide to do nothing.[19]

Since price cutters are frequently quantity buyers it is quite likely that the manufacturer has been allowing price concessions to them. While these may be warranted by reduced costs of marketing or production, they encourage price cutting. If this is the case, he may attempt to restrain the practice either by raising his price to the price cutters or by lowering it to the others. If he raises the price he will offend the price cutters. If he lowers it to the others he will still offend the price cutters and at the same time reduce his average profit margin per unit of sales with no assurance that the small dealers will increase their sales enough to offset this reduction. In either case the sales of the former price cutters may decline if their price advantage is eliminated, while sales of the others may not increase. Nor will the elimination of price differentials necessarily eliminate price cutting. In the first place the various reasons for the cost advantages of large retailers remain, and in the second place they may be willing to sell the well-known branded product as a leader, even though they may realize no profit or even a loss.

[19] A fourth alternative is sometimes used. The manufacturer may use two brands, maintaining the price of one and permitting price cutting on the other.

Another alternative available to the manufacturer is to undertake to maintain his resale price, either with or without price differentials to different customers. Successful price maintenance may help him to retain or increase the patronage of the small dealers who might be driven from the field by price cutting. These dealers may have been making no effective effort to sell his product or may have made definite attempts to sell substitutes rather than the manufacturer's product in competition with the price cutters. If sales to smaller dealers increase by more than any loss of sales to his large customers and sales costs do not rise disproportionately, he may feel that resale price maintenance is advantageous to him. Moreover, a market composed of a large number of small dealers may be more certain than one composed of a few large dealers. Finally, he may not wish to have the public gain the impression that his product can be profitably sold at less than the regular price.

On the other hand, price maintenance may have distinct disadvantages for the manufacturer. It will cause a maximum of dissatisfaction among his former price cutters. Their purchases are likely to decline, and they may even refuse to purchase his product. This may be serious since in a number of fields large stores operating on a cut-price basis account for a large proportion of all retail sales. Moreover, it may be less expensive for the manufacturer to sell to a few large customers than to maintain a market composed of a large number of small stores. If sales to large buyers fall off, the manufacturer can maintain his former volume only by increasing sales to small customers. But the smaller dealers for whom the prices are maintained may take his new policy for granted and make no special efforts to sell the product in large volume. If this happens he may find it necessary to increase his effort to sell them, and he may find it necessary to increase his consumer advertising.

Moreover, in the face of price maintenance, a few large organizations have increased their effort to push their own private brands in competition with the advertised brands on which retail prices are maintained. The large New York department store, R. H. Macy and Company, for example, sells a complete line of cosmetics under its own name, and some mail order houses make it a point to compare the prices charged for their own private brands with the maintained prices of similar well-known manufacturers' brands. But only the largest retailers can afford the expense involved in creating an important consumer good will for their own brands. More commonly the promotion of private brands rests on the simple expedient of selling them at low prices which offset the good will of the well-known, price-maintained product in the consumer's eyes. Ability to do this undoubtedly varies widely among products and retailers, but it is often done with marked success.

A further difficulty which may deter the manufacturer in some cases is the difficulty of enforcing a policy of resale price maintenance. This must be done primarily by the manufacturer, since the legal theory is that the manufacturer is preventing injury to the good name of his product by preventing resale at a price which might reflect upon the quality of the good, or which represented an attempt by the seller to arrogate to himself part of the good will attached to the brand name by cutting the price of the product. The enforcement problem, always difficult and expensive, has been further complicated by recent court actions.

Legal Aspects of Resale Price Maintenance

The legal framework for resale price maintenance has passed through several periods. Price maintenance was legal under the common law until 1911, after which a series of Supreme Court decisions considerably limited the legal means for implementing a resale price maintenance policy. In that year the Supreme Court, in the *Dr. Miles Medical Company* case, held that an agreement between a manufacturer and his jobbers and retailers to maintain prices was illegal under the Sherman Anti-Trust Act. In the *Beech-Nut Packing Company* case the Court held that, while a simple refusal to sell was legal, a system whereby the distributor and his dealers use cooperative methods for reporting price cutters was illegal. In other decisions the Court also held that neither the copyright laws nor the patent laws legalized resale price maintenance.[20]

These cases left the possibilities of effective price maintenance programs severely circumscribed. The main possibilities were: a manufacturer could refuse to sell to price cutters, but he could not enter into a systematic enforcement policy with his distributors; he could sell on consignment while retaining title to his goods, assuming that he had the financial resources for this and was willing to undergo the resulting deterioration in inventory control; or he could market only through his own retail stores or salesmen.

In an effort to make resale price maintenance policies easier, bills legalizing the practice were presented to the Congress from 1914 until the passage of the Miller-Tydings Act of 1937. At the same time efforts were made to legalize resale price maintenance in the states. The pressure behind these bills in the earlier years seems to have come largely from manufacturers. Then as whole-

[20] *Dr. Miles Medical Co.* v. *Park & Sons Co.*, 220 U.S. 373 (1911); *Federal Trade Commission* v. *Beech-Nut Packing Co.*, 257 U.S. 441 (1922); *Straus* v. *Victor Talking Machine Co.*, 243 U.S. 490 (1917); and *Bauer & Cie.* v. *O'Donnell*, 229 U.S. 1 (1913).

salers and small retailers in larger and larger numbers began to feel the competition of large retailers, and particularly that of the expanding chain store businesses, they began to take on the burden of advocating these laws. Since 1931, when the first successful state law was passed in California, 45 states have legalized resale price maintenance.[21] While these laws were held to be constitutional during the thirties, similar contracts in interstate commerce continued to be illegal. To meet this situation Congress was finally prevailed upon to pass the Miller-Tydings Act of 1937. This Act amended the Sherman Act of 1890 to permit manufacturers in interstate commerce to make contracts under the state resale price maintenance laws without violating the Sherman Act.

Provisions of the State Acts. The state resale price maintenance acts typically provide that the producer or owner of a commodity that bears his brand, trade-mark, or trade name has the legal right to enter into contracts that stipulate the minimum or actual price at which it shall be sold at successive stages in the trade channel. The key feature of all of these laws, except Virginia's, is the so-called "nonsigner" clause. This clause provides that the signing of a contract with one retailer binds all other retailers to observe the stipulated price, and all wholesalers are likewise bound if there is a single wholesaler contract. It should be pointed out that the contracts made legal under these laws are vertical contracts. They do not legalize horizontal contracts among producers, or among wholesalers, or among retailers.

The McGuire Act. Many proponents of resale price maintenance regarded the Miller-Tydings Act as ending the earlier Supreme Court doctrine condemning resale price maintenance contracts and arrangements under the Sherman Act, and a considerable increase in the use of this policy resulted. However, in 1951 some rapid changes in the legal status of resale price maintenance began. In the *Schwegmann Brothers* case the Supreme Court invalidated the nonsigner clause of the various Fair Trade Acts where interstate commerce was involved or affected.[22] While all the implications of this decision were not clear, it was evident that a severe blow had been struck at resale price maintenance. The proponents of fair trade immediately organized a campaign to bring back the nonsigner clause in interstate commerce. This was accomplished with the passage of the McGuire Act of 1952. This Act states that "willfully and knowingly advertising, offering for sale, or selling any commodity at less than the price or prices prescribed in such contracts . . . is actionable at the suit of any person damaged thereby."

[21] Many of these laws are inoperative today, as the discussion below indicates.
[22] *Schwegmann Brothers* v. *Calvert Distillers Corporation,* 341 U.S. 384 (1951).

Recent Legal and Economic Developments

In spite of the passage of the McGuire Act, resale price maintenance has been on the defensive in the last decade or so. This has been partly a matter of economic developments and partly of legal developments, with changes being particularly rapid in the appliance industry.

In the thirties many branded major appliances were placed under fair trade. Margins were set at substantial percentages with the idea that significant selling effort on the part of dealers needed to be recompensed. Under the conditions of expanded markets in the forties and fifties these margins often were unrealistically large. Efficient large volume dealers found it possible to cut prices substantially below listed levels and still make a profit. Under the impact of the discount houses, particularly, fair trade in major appliances rapidly disintegrated.

This process was hastened for some commodities by the increasing saturation of markets so that more and more sales were to persons who already had a unit and wished replacement. Such people demanded an allowance for their old appliance. Fair trade prices became merely a starting place for bargaining and the listed prices became quite unrealistic. Under these conditions a number of manufacturers have either dropped resale price agreements or reduced their enforcement efforts.

Price maintenance for small or so-called "traffic" appliances hung on more persistently, and its decline has been more closely tied in with legal developments than in the case of major appliances. Most important has been the trend of recent decisions of state courts on the constitutionality of state resale price maintenance laws. About two thirds of the states have had their laws tested in the appropriate state courts. In about half of the cases the courts have held the laws to be constitutional. Of major significance, however, is the fact that in recent years the trend has been strongly unfavorable to resale price maintenance. Most of these recent decisions have been based on the finding that the nonsigner clause violated the due-process clause of the state constitutions. Thus while at the high tide of these laws 45 states had operative laws, today more than one third of them have become inoperative.

Other developments have further eroded their effectiveness in the remaining fair trade states. One loophole of considerable significance is the ability of price cutters in non-fair trade jurisdictions to sell by mail in fair trade states without regard to resale price maintenance contracts. So long as the buyer takes title to the merchandise in the non-fair trade state the goods are considered to be in interstate commerce and not subject to the state fair trade

laws.[23] Again, problems of enforcement, always great, show signs of becoming more onerous for companies with fair trade policies. Thus injunctions against price cutters often will not be granted by the courts unless there is "a pattern of enforcement." [24]

As a result of these increasing difficulties even some companies which have been most enthusiastic about fair trade, and most vigorous in attempting to enforce it, have dropped out of the ranks of fair traders. One authority, writing in 1959, summarized the situation as follows: "The paths of many manufacturers with regard to fair trade have been leading in the same direction, but at different speeds. Westinghouse, Lionel, and Shaeffer abandoned fair trade over two years ago. Eastman Kodak, Revere, and Bell & Howell followed last year; and 1958 has seen some of fair trade's staunchest proponents such as General Electric, Sunbeam, McGraw-Edison, and Revere abandon this form of price control." [25]

Perhaps the most dramatic case of abandonment was that of the W. A. Shaeffer Pen Company. For years this company had vigorously enforced its program. In 1954 and 1955 the company cut 700 dealers off its authorized list, persuaded almost 400 others to sign resale price maintenance agreements, and obtained 81 injunctions against others who refused to abide by the list prices. This program cost the company two million dollars and on an annual basis enforcement expenses were running about 4 per cent of sales. Yet in December of 1955 the firm announced it was no longer following a fair trade policy. A company spokesman explained that Shaeffer wanted to get its products into the outlets where a large portion of the public was doing its buying—in other words into the discount, catalog, and mail order houses.[26]

Perhaps the most important defection from a fair trade policy in the area of small appliances was that of General Electric. While the company had abandoned resale price maintenance for major appliances in 1954, as described above, it had continued a policy of vigorous enforcement for its small appliances. In 1958, however, General Electric abandoned the program for these items also. In addition prices were cut and margins of dealers reduced. There is no doubt that the changes were a result of the growing importance of the discount houses. The action was significant not only in itself but because it

[23] *General Electric Co.* v. *Masters Mail Order Company of Washington, D.C.*, 78 S. Ct. 32 (1957).

[24] See, for example, *General Electric Co.* v. *Klein-on-the-Square, Inc.*, New York Supreme Court, Special Term, Part IV, 1953, and *Ramo* v. *Excel Pharmacy, Inc.*, New York Supreme Court, May 1959.

[25] Stewart Munro Lee, "Problems of Resale Price Maintenance," *Journal of Marketing*, January 1959, p. 275.

[26] *Ibid.*, pp. 278–9. A number of similar case histories are given in this article, including some where companies have continued fair trade.

triggered the departure from fair trade of a number of other companies so that today resale price maintenance has few significant footholds in appliances or other hard goods. Its remaining strength is primarily in drugs, liquor, books, and similar products. Even for these the problems of enforcement of the kinds described above have made effective programs increasingly difficult.

The Consumer and the Results of Resale Price Maintenance

From the point of view of the public there seem to be three main results from resale price maintenance which argue against the policy. First, it facilitates uniform pricing among brands; second, it tends to center rivalry on nonprice competition; and third, it probably raises the average price at which such goods are sold. While objective information is not available for the most part on these points, the logic of the situation seems to support them.

At least as a legal matter, uniform pricing among brands is of course not a matter of agreement. During none of the periods of varying legal status have horizontal agreements between sellers at any level been permissible. However, no matter how much the manufacturer may desire to shift attention toward nonprice competition, price is still an important consideration to the consumer for most products. Before setting the price to be maintained the manufacturer is likely to look at the price of those products which are the closest substitutes for his own brand. The closer other products come to being substitutes for his own brand, the more important it is for him to establish prices which will not give his competitors any undue price advantage.

To the extent that price competition is prevented, there is a tendency to turn to nonprice competition. Manufacturers will try to appeal on the basis of improved quality, special features, or increased advertising and selling outlays. To the extent that maintained prices make it impossible for low-cost merchants to sell at the low prices their lower expenses warrant, they are likely to spend the surplus in pushing other brands or in improving their service. The development of minimum-service, low-cost stores has been welcomed as a means of affording lower prices to the large number of consumers who are willing to forego service. It seems unreasonable that dealers whose costs are low because of reduced service or greater efficiency should be denied the use of the price appeal, and that the consumer should not receive the price advantage which results.

Whether these maintained prices result in a higher average price for these goods or not has been the subject of considerable controversy. It is argued that maintained prices tend to be high prices since the avowed purpose is to make possible a higher profit to manufacturer, wholesaler, and retailer and

to eliminate cut-price selling. In many cases they have been set high enough to give an adequate margin for the least efficient or smallest outlets.

The counter arguments are vigorously stated by the proponents of resale price maintenance. It is said that with price maintenance the dealer is able to make a reasonable profit on all items, rather than having to make an exorbitant profit on less competitive items to make up for his losses on price-cut items. There is also some indication that while the prices of these articles rise in former price-cutting establishments they tend to fall in other stores,[27] though whether these offset the increases of the price-cutting establishments seems doubtful, especially since the latter tend to be the volume outlets.

Moreover, while the owner of the brand has a monopoly of his product, in setting his price he must consider the strength of the consumer's desire for his product and the possibility of substitution. Thus maintained prices are not necessarily high prices; rather they tend to place all dealers on the same price basis, high or low as the case may be.

Conclusions

The significance of resale price maintenance is difficult to estimate. There is little objective evidence on the arguments for and against the practice as far as its effect on the public is concerned. Moreover, it is probably easy to overestimate its importance. Estimates of the proportion of the total volume of retail trade under price maintenance vary from as low as 5 per cent to a possible 15 per cent, but with most estimates nearer the lower figure. The majority of families spend the largest part of their income for food, housing, household operation, clothing, and automobiles,[28] and in these fields resale price maintenance is used little or not at all. The lines in which the greatest amount of resale price maintenance continues to be found are drugs, cosmetics, toilet goods, books, stationery supplies, liquor, and cigars, and the majority of consumers spend but a small part of their income for such products.

STATE LOSS-LIMITATION LAWS

Loss-limitation laws affecting the price policies of businessmen are now in operation in some 30 states.[29] These laws are designed to set a lower limit

[27] See E. T. Grether, "Experience in California with Fair Trade Legislation Restricting Price Cutting," *California Law Review*, September 1936, pp. 662–76; and Reinhold Wolff and Duncan Holthausen, "The Control of Retail Prices under Fair Trade Laws," *Dun's Review*, July 1938, pp. 15 ff.

[28] See Tables 5-8 and 5-9 in Chap. 5.

[29] In several states they have been declared unconstitutional.

below which goods may not legally be offered for sale.[80] The chief object of these laws is to discourage price cutting, largely in the interest of the small independent retailer. They are particularly aimed at the elimination of "leader" or "loss-leader" selling of merchandise and selling below cost, as defined in the acts. These laws are often thought of as supplementing resale price maintenance laws by setting a lower limit to prices of unbranded merchandise as well as branded goods the prices of which are not maintained under price maintenance laws. The weaker the status of resale price maintenance becomes the more important the unfair practices acts become as a means of controlling price cutting.

In general the loss-leader laws fall into two groups, depending upon how "cost" is defined. In one group, called the definite laws, cost is based on invoice or replacement cost, either alone or more commonly plus a fixed percentage markup with 2 per cent for wholesalers and 6 per cent for retailers being the almost universal figures. In a second somewhat smaller group of indefinite laws, it is invoice or replacement cost plus all or an enumerated part of the cost of doing business.[81] It is to be noticed that these laws are horizontal covering all commodities and that they are mandatory, rather than being vertical and permissive as with the resale price maintenance laws. They thus constitute a broader attack on price cutting and the use of loss leaders than do the resale price maintenance laws.

Because of the way in which "cost" is defined in these laws, it has generally been assumed that they have little over-all effect on prices and so there has been less objection to such acts by manufacturers, retailers, and economists than there has been to resale price maintenance laws. It is not clear that such relative indifference is justified, although sufficient objective evidence to establish their significance is lacking.

Enforcement of the loss-limitation laws has been quite uneven. They do not establish an enforcement agency, but rely upon the attorneys general of the states or upon county attorneys for action against price cutters. These officers have often not had the resources or the interest to follow through vigorously.

[80] Laws legalizing the control of resale prices are commonly referred to as "fair trade" laws. Loss-limitation laws are frequently referred to as "unfair trade" laws or "unfair practices" laws, but as they are also frequently called "fair trade" laws an element of confusion is sometimes injected into the classification. The term "loss-limitation" does not cover the apparent intent of some of the laws which indicate that prices must cover the cost of the goods plus all the costs of doing business, but in practice this has not usually been attempted, and the general effect has been to limit losses, not to cover all costs.

[81] These include some or all of the following: wages and salaries, rent, interest, selling, delivery, and advertising costs; accounting costs, depreciation and maintenance; losses, taxes, fees, licenses, and insurance.

This rather desultory record of legal enforcement does not necessarily measure their effectiveness, however. Retailers and wholesalers have sometimes formed associations, or relied on existing trade associations, to help in enforcing these acts. In the states with the definite laws the associations can rely on their knowledge of prevailing market conditions in their efforts to search out violations. They may then bring pressure privately on firms suspected of violation or bring the matter to the attention of the attorney general.

In the states with the indefinite laws, the correct legal markup is more difficult to determine. The very vagueness of the appropriate cost, however, coupled with the lack of knowledge and understanding of their costs by many businessmen, can sometimes be used to bring about general minimum prices. An interesting example of how such associations bring pressure, and also of how they may affect price levels, occurred in the state of Washington with the price of cigarettes. Immediately upon passage of the Washington Unfair Practices Act of 1939, "No time was lost in making the first increase of 2¢ a pack. After this higher price was generally established among merchants and accepted without too much protest by consumers, a further increase of 1¢ was put into effect. The method of procedure was to mail to all retail merchants handling tobacco products a detailed list of 'Suggested Retail Tobacco Prices.' The card was unsigned but it was postmarked from Olympia, the state capitol, and some merchants, at least, 'supposed' it was sent by an official agency of the state government." [32]

Various other tactics have been used. The association may announce (incorrectly) in the newspapers that, in the future, sales below a given price are illegal. Non-cooperating retailers may be visited by a delegation from the association. Compliant prosecuting attorneys will sometimes send a warning letter. While the recalcitrant dealer may in fact be doing nothing illegal, particularly if he is a small merchant he is likely not to know this, and so such pressures may bring him into line.

In the absence of conclusive evidence, it is to be remembered that these laws are intended to cover all goods sold, so that even with poor and uneven enforcement, their effects may reach a quantitatively significant portion of the market in absolute terms. To the extent that they are effective they will tend to raise prices on at least some goods, and perhaps the general price level. This is true whether the law is of the definite or indefinite type. While the common specified minimum markup of 2 and 6 per cent of the definite laws is certainly not equal to average cost for most firms, it may still be higher than cost, or at least what would otherwise be accepted markups, on some

[32] Henry A. Burd, "'Cost' Under the Unfair Practices Act," *Journal of Marketing*, October 1942, p. 147.

goods. In the states with indefinite laws, particularly for firms without detailed cost data for individual products or groups of products, the tendency is to use over-all average cost markups (in a few cases the courts have required over-all average cost to be used). Since different categories of goods will ordinarily bear different markups based on cost analysis, experience, or custom, the use of an over-all average markup will raise the price of some goods, although there may be some offsetting lowering of markups on other goods.

On the other hand, the costs to be covered are usually based on the firm's own costs. To the extent the individual firms understand this, and the laws are not used as a cover for raising and fixing the general price level of various goods, the price raising impact of the indefinite type of loss-limitation law is probably limited.

QUESTIONS FOR DISCUSSION

1. Do you believe quantity discounts should be based only on demonstrable differences in cost? Explain in terms of the effects on sellers, buyers, and the public.
2. Is it wise public policy to make price discrimination among customers legal when it is done in good faith to meet the prices of competitors?
3. Under what circumstances can a requirement that advertising allowances or other services must be furnished to customers on a basis proportionate to their purchases be justified? Are there any ways such a requirement may interfere with the competitive ability of the seller?
4. Assume that you are the manufacturer of a distinctive type of one-piece winter pajamas for children. Having manufactured a high quality garment for many years, and advertised consistently in the major women's magazines, you have built up a fair degree of recognition and preference for your brand of pajamas. You also count rather heavily on the advertising of your numerous dealers to push your brand during the peak selling season in the fall. Nevertheless, there are a number of fairly similar, though less well-known, brands on the market. Most of these suggest resale prices, but do not maintain them under the resale price maintenance laws. In deciding on your own price policy would you adopt a fair trade program? Explain what considerations pro and con lead you to your decision?

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See also the references listed at the end of Chapter 27.

29. GOVERNMENT REGULATION OF MONOPOLY AND COMPETITION

Any economy must have some guiding principles as to the type of market structure within which the forces of manufacturing and marketing are to operate. Decisions as to what form of marketing structure will best promote the public interest must be made through the government, with an almost infinite range of possibilities from which to choose. Few problems in the realm of public policy arouse more debate than this one. At one extreme is the view that the government should render no aid to business and impose no regulations upon it. At the other extreme is the view that all productive facilities should be owned and controlled by the state. In between are possibilities for a multitude of combinations for varying degrees of government regulation of and aid to business and for mixed economies with varying degrees of public ownership along with private ownership of the means of production.

ALTERNATIVE MARKET STRUCTURES

Laissez Faire

The first point of view, the extreme laissez-faire policy, is seldom held. A more moderate laissez-faire view was expressed by Adam Smith in the third quarter of the eighteenth century in the famous *Wealth of Nations* where he advocated leaving to government only the protection of society from violence, injustice, and oppression, and the performance of certain necessary public works which could not be profitably developed by private firms.[1]

[1] *The Wealth of Nations*, Cannan's ed. (London: Methuen, 1904), Vol. II, p. 184. At about the same time in France the Physiocrats were making the same plea for laissez faire against the restrictions of mercantilism.

Smith also recognized the possibility of collusion among businessmen: "People of the

In contrast to Smith's philosophy were the conditions actually existing in his own country (England) at the time of writing, conditions against which he was protesting. Thus in marketing alone,

> . . . practically all combinations and almost all of the modern forms of commercial organization were unlawful. The business of the middleman was unlawful; the business of the modern wholesale grocer was unlawful. It was a criminal offense to buy food or victuals which were on their way to the market for the purpose of reselling them, or to buy, for purpose of resale, large quantities of goods at any time.[2]

Government Ownership

The extreme view that the government should own and control all productive facilities is little heard in the United States, although it is more frequently expressed in many other countries and practiced in some. In this country it is of little significance and need not be discussed.

Government Intervention

In between these two extremes, advocates of all degrees of government intervention and of government ownership of particular parts of the economy will be found. Historically the American belief in individual freedom has carried over into the economic sphere. The idea of minimum interference with business consistent with the public welfare, and the corollary of free competition, has been the ideal of most people. The basic issue involves the question of how much freedom is consistent with the public welfare.

Until after the Civil War, it was generally felt that the public welfare would be adequately taken care of in the automatic fashion envisaged by Adam Smith if businessmen were simply let alone to compete with one another. In the last quarter of the nineteenth century the growth of giant business combinations, or "trusts," and the setting aside of competition in many fields by private business led to legislative intervention to try to break up monopoly and restore the beneficial effects of competition. The Sherman Anti-Trust Act of 1890 and the various state antitrust acts were certainly

same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But although the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary." *Ibid.*, Vol. I, p. 130.

[2] A. A. Bruce, "Laissez Faire and the Supreme Court of the United States," *The Green Bag*, Vol. XX (1908), p 553.

governmental interventions in business, but not perhaps really departures from tradition. The English Common Law provided strong precedent for governmental intervention against monopoly and restraint of trade in favor of competition. Thus began a trend of increasing governmental interest in and regulation of business.

The questions that arise out of the relation of the state to marketing make up an important part of the broader problem of the relation of the state to business. In the United States, as in other countries, governmental agencies are more and more investigating and regulating trade and industry. This has in large part developed from the fact that some of the profit-seeking operations of businessmen appear to be in conflict with the broader interests of society. Those aspects of marketing operations which are most commonly criticized are in large part side effects from competition—the struggle for business and the efforts made by businessmen to control or eliminate certain competitive practices, as well as their efforts to curtail competition and even to establish monopolies. To an increasing extent our federal, state, and municipal governments have attempted to mitigate certain results of competition which are thought to be contrary to the interests of the general public. Governments have also sought to control, and where necessary to eliminate, the efforts which businessmen themselves undertake in their desire to curtail competition or to eliminate what they consider to be undesirable competitive practices.

Intervention to Promote Competition. It is noteworthy, however, that government intervention to promote the general welfare has commonly taken the form of alterations in the structure of the market. The effort has been to set up a system of general rules which would establish a market framework which would automatically bring about the public welfare through the independent decisions of businessmen themselves, rather than by substituting the decisions of governmental officers for those of businessmen. These rules are of two types. One group is designed to protect the individual businessman from socially undesirable acts of other businessmen. The other group establishes rules which protect consumers from socially undesirable acts of businessmen. Thus governmental intervention in this country is still largely in the laissez-faire tradition of automatic market forces bringing maximum welfare through the independent decisions of businessmen. Although the number of rules which businessmen must observe in their day-to-day operations has greatly increased, the basic effort is still to set up the most desirable market structure in the expectation that it will lead to good results for the public.

Intervention to Limit Competition. Some exceptions to this general statement have grown up with the increase of governmental intervention. One is

the enactment of laws which are designed as exceptions to the view that the public welfare is advanced by the promotion of competition. Examples would be the resale price maintenance laws, the numerous acts to control production and raise prices in agriculture, the chain store taxes still existing in a number of states, and the numerous state laws to protect businessmen within one state from the competition of out-of-state firms. These laws permit or enforce monopolistic practices in particular areas of the economy for the primary benefit of the participants, although it is sometimes claimed that they will also benefit the public. Another exception, still relatively unusual, is actual government ownership and operation of business. This has occurred mainly in the field of public utilities, either with the idea that the action itself is in the public interest, or that public operations will provide a "yardstick" by which to measure private operation in the same field.

Intervention to Aid Business. One other phase of governmental intervention in the marketing process has become important with the passage of time. This is the idea that government may take positive actions to help business. Activities designed to promote efficiency in marketing have increased substantially in the last several decades. Even these, however, have developed within the traditional concept of the appropriate relation of the government to business since in general the aids are available impartially to all members of the various groups for whom they are intended.

Classification of Governmental Activity. Thus governmental activities that bear directly on marketing can be conveniently divided into three groups: [3] (1) efforts to attain a satisfactory market structure by protecting businessmen from the acts of other businessmen through (a) the effort to control monopoly and monopolistic tendencies, and (b) the effort to maintain and improve competition and competitive practices; (2) efforts to attain a satisfactory market structure by rules designed to protect directly the consumer; and (3) efforts to promote efficiency in marketing.

In this chapter governmental efforts to attain a satisfactory competitive market structure are considered. In Chapter 30 the exceptions will be pointed out and governmental efforts to protect the consumer and efforts to promote efficiency in marketing will be considered.

The divisions used are not mutually exclusive. In particular the maintenance of competition through the control of monopoly and monopolistic

[3] An excellent source of information on the activities of the federal government is *The United States Government Manual*, The U.S. Information Service, Office of Government Reports, Executive Office of the President, published three times a year. It is available from the Superintendent of Documents. It is designed to be "a reference book of integrated authoritative information on the organization and functions of the departments and agencies of the Federal Government."

practices and attempts to elevate the plane of competition by curbing some of its undesirable aspects have been closely related in the development of federal and state regulation of private business enterprise. The desire to maintain competition among businessmen has been a basic consideration in American legislative policy, and it is interesting to notice how the idea of curbing undesirable competitive practices has grown up to complement the policy of direct monopoly control. This is evident in the basic policy statements of the three major antitrust laws. Thus the Sherman Act of 1890 declares that:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is hereby declared to be illegal. . . .
>
> Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor. . . .

Section 2 of the original Clayton Anti-Trust Act of 1914 in dealing with marketing topics shifted the emphasis to unfair competitive practices. It declared,

> That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities, . . . where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

Also placing its emphasis on the level of competition, Section 5 of the original Federal Trade Commission Act of 1914 stated,

> that unfair methods of competition in commerce are hereby declared unlawful.
>
> The commission is hereby empowered and directed to prevent persons, partnerships, or corporations, except banks [which are otherwise controlled], and common carriers subject to the acts to regulate commerce, from using unfair methods of competition in commerce.

The change in the emphasis of these three quotations from restraint of monopoly under the Sherman Act to emphasis on discrimination which lessens competition and leads to monopoly in the Clayton Act, and to unfair methods of competition in the Federal Trade Commission Act indicates the way in which the two aspects of the control of the market structure have grown to become complementary with each other. Thus the desire to maintain competition brought forth the Sherman Act as well as the antitrust acts of most of our states.[4] But recognition that competition itself may lead to unfortunate

[4] These state acts apply, of course, only to intrastate commerce.

results brought the ban on price discrimination in the Clayton Act and the declaration in the Federal Trade Commission Act that "unfair methods of competition" are illegal.

EFFORTS TO CONTROL MONOPOLY AND MONOPOLISTIC COMPETITION

While monopoly is generally considered undesirable, there are some fields where exceptions have been made as a matter of public policy. Two important considerations are involved in the formation of monopolistic organizations, such as public utilities, and of combinations which tend to become monopolistic. One is the operating efficiency and economy that may result from unified control and operations. This reason is commonly advanced when mergers or combinations are formed, and this is one reason (along with public convenience) for the public's acquiescence in the formation of monopolies in the public utility field. The other consideration is the desire of the owners of the monopoly or combination to control competition and price.

When the public recognizes that the greatest industrial efficiency can be realized under conditions of complete or partial monopoly (whether local, sectional, or national), it also generally demands some form of control over the price and output policies of the monopoly in order that the benefits of this efficiency may be assured to the public. This can usually be accomplished only through some type of governmental activity designed in whole or in part to control monopoly and monopolistic tendencies. This control is sometimes exercised by means of actual ownership and operation by agencies of the state. The postal service, for example, is almost universally owned and operated by central governments, and water supply systems are commonly owned and operated by municipalities. Local transportation systems, electric and gas plants, likewise, are frequently municipally owned and operated. But when public utilities which are monopolistic in character are privately owned they are regulated by the state through agencies of the federal, state, or municipal governments. The state also supervises and limits the use of patents and copyrights whose owners are given monopoly privileges by law.

The desirability of monopoly outside a few limited fields is not, however, generally accepted in the United States. The evidence is by no means conclusive that centralized control of industrial operating units outside the field of public utilities always leads to economies which are important enough to justify monopolistic operation and, particularly, the methods of competition and market control which sometimes accompany monopoly. The general

attitude toward business in this country is based on a belief that the public will be best served if competitive rivalry is maintained within proper bounds. Hence legislation has been passed and administrative agencies have been empowered to prevent practices which tend to establish monopolies.

Common Law

The common law doctrine relating to restraint of trade and conspiracy to monopolize came to this country from England and developed here largely in the state courts. Important mainly during the nineteenth century, the doctrine as developed by the courts held illegal such things relating to marketing as agreements among competing firms to divide territory, to form price-fixing associations, to effect pooling arrangements, or to use common marketing agencies. However, the common law proved inadequate to protect the interest of the public from the monopolistic aspects of the growth of industry because action could only be taken by an injured competitor. Because of the large public interest in these matters it came to be felt that it was necessary to deal with monopoly by statute.

The Sherman Act

The basic idea of the Sherman Act of 1890 was to eliminate monopoly where it was designed to avoid competition or to make competition impossible. To achieve this purpose the Congress in essence put the common law doctrines of restraint of trade and monopoly into statutory form. The law was framed very broadly in the hope of bringing under its scope any actions which might restrict competition. The law forbids (1) contracts, combinations, or conspiracies in restraint of trade, and (2) monopolies or attempts to monopolize trade or commerce. Unlike many more recent regulatory acts, no administrative machinery such as a commission was set up to enforce the law. The duty of prosecution, therefore, falls upon the Attorney General, while enforcement and interpretation depend upon the courts. Since cases must be tried like any other court proceeding and since the courts rule only upon the specific point at issue, severe limitations have appeared on the ability of the Sherman Act to deal with the complex problems of modern industry.

This has given rise to an interesting device known as the consent decree. This is simply an agreement reached out of court on the issues involved between the Attorney General and the defendants. Between them they agree, for example, on a code of practice for the industry. The proper court then reviews the decree and if it is approved it has the force of a formal court

decision. This device has overcome many of the difficulties of court procedure since it is much more flexible, and also less expensive. It is objected to mainly because it involves much "horse trading" of concessions and maneuvering for position.

It is difficult to appraise the effectiveness of the antimonopoly policy. It seems to have undergone a very gradual increase in effectiveness. Early court decisions almost nullified the law by giving a very narrow interpretation to what could be considered interstate commerce by declaring that manufacturing was not commerce.[5] This ruling was in effect reversed in the *Northern Securities Company* case, and a number of successful prosecutions of monopolies such as the oil and tobacco trusts took place.[6] However, the government was hampered in its attempts to deal with monopoly as such by the so-called "rule of reason" introduced in these latter two cases in which the defendants were found guilty, not because they restrained trade but because the restraint was unreasonable. A further difficulty arose in the famous case of the *U.S. v. U.S. Steel Corporation* in which it was stated that "the law does not make mere size an offense or the existence of unexerted power an offense." [7]

In consequence the Antitrust Division was frequently in the position of attempting to deal with the symptoms and abuses of monopoly without being able to get at the monopoly itself which caused them. In recent years, however, this situation has changed substantially. Several recent decisions in the opinion of many students have opened up new possibilities of antitrust enforcement.

In *U.S. v. Aluminum Company of America* the court held that "Congress . . . did not condone 'good trusts' and condemn 'bad' ones; it forbade all." The case did away with the idea that size is immune to the law with the words "Throughout the history of these statutes it has been constantly assumed that one of the purposes was to perpetuate and preserve for its own sake and in spite of possible cost an organization of industry in small units which can effectively compete with each other." [8] In the *American Tobacco Company* case the Court held essentially that the power to exclude competitors is illegal even though not exercised, and also that "No formal agreement is necessary to constitute unlawful conspiracy." [9]

[5] *U.S. v. E. C. Knight*, 156 U.S. 1 (1895).

[6] *Northern Securities v. U.S.*, 193 U.S. 197 (1904); *Standard Oil Co. of N.J.* et al., v. *U.S.*, 221 U.S. 1 (1911); *U.S. v. American Tobacco Co.*, 221 U.S. 106 (1911).

[7] *U.S. v. U.S. Steel Corporation*, 251 U.S. 417 (1920).

[8] *U.S. v. Aluminum Company of America*, 148 F. (2d) 416 (1945). While this was not a Supreme Court decision, it has the force of a Supreme Court ruling. The Supreme Court was unable to get a quorum to hear the appeal from the District Court, and so this appeal was certified to the Second Circuit Court of Appeals for final decision.

[9] *American Tobacco Company v. U.S.*, 328 U.S. 781 (1946). The other two companies were Reynolds and Liggett & Myers.

The more stringent view of what constitutes monopoly within the meaning of the Sherman Act established in these two cases has been followed up by a number of court cases and consent decrees. While the courts have not shown much interest in actually breaking up established companies, in a number of instances they have ordered changes in company practices to reduce market domination.[10] A significant exception occurred in the *Paramount Pictures* case in which vertical disintegration of distribution and exhibition affiliates from the producing firm was required.[11]

Historically, nevertheless, enforcement of the antitrust laws in the courts, as must be done under the Sherman Act, has not been completely satisfactory. From the standpoint of public policy, it would appear that the problems of monopoly and restraint of trade are too complex to be solved satisfactorily in the courtroom. The Sherman Act makes antitrust enforcement primarily a legal battle and the cases do not show a consistent approach. This difficulty became apparent early in the history of antitrust legislation and was partially corrected by the Federal Trade Commission Act which resulted in part from the idea that the courts were inadequate to make the extensive investigations and to supply the continuity of policy which is desirable. However, no such solution has yet been applied to the Sherman Act and the difficulties of lack of continuity of policy and uncertainty of law continue.

EFFORTS TO MAINTAIN AND IMPROVE COMPETITION

Efforts of the state to control the plane of competition are designed to retain the benefits which result from competition while excluding those manifestations which seem to thwart the best interests of society. Specifically they are designed to protect businessmen against competitive practices that will hinder their ability to compete, and hence tend to lessen competition and tend toward monopoly, and to protect business and consumer purchasers against undesirable practices of vendors. Governmental efforts to control the plane of competition include efforts to restrict unfair trade practices and the investigation of business practices by legislative and administrative bodies.

If manufacturing and marketing are to achieve the best results from the point of view of the public at large, competition must be so ordered that those individuals, firms, and corporations which are most competent in mak-

[10] See, for example, *U.S.* v. *United Shoe Machinery Corp.*, 110 F. Supp. 295 (1953), aff. 347 U.S. 521 (1954); and *U.S.* v. *United Fruit Co.*, 1958 Trade Cases par 68941 (E. C. La.). An unusually thorough and interesting economic analysis is available of the United Shoe Machinery case in Karl Kaysen, *United States* v. *United Shoe Machinery Corporation* (Cambridge: Harvard University Press, 1956).

[11] *U.S.* v. *Paramount Pictures, Inc.*, et al., 334 U.S. 131 (1948).

ing and selling will survive the struggle with their less competent competitors. This does not mean that it is to the interest of society that the largest or the wealthiest, or the most unscrupulous, shall succeed; but rather that, regardless of whether he be large or small, he who produces and markets the best product at the lowest cost, or who can market the products of others most effectively and most economically, shall succeed if he operates honestly. When carried on within limits, competition tends toward the survival of those producers and middlemen who can best serve society, and through them results in the development and perpetuation of the best techniques.

Unfortunately the profit seeking which underlies the competitive system often leads to methods of competition which, however effective they may be from individual points of view, cannot be said to be to the best interest of society. That is, some methods of competition may help those who use them to survive, but they do not tend to promote more efficient manufacturing and marketing because they hamper and may even cause the failure of less powerful or more scrupulous competitors who are otherwise efficient. Such methods are looked upon as unfair to competitors and as economically and socially undesirable. Other practices may not harm direct competitors, but they may injure some or all of those who purchase a vendor's product, whether they are business or consumer purchasers. Such practices are also undesirable. Practices of both types are now commonly called "unfair" methods of competition.

The history of legislation designed to regulate unfair business practices often shows an interesting similarity of pattern. First, practices that are considered undesirable are aired in the press and by interested and often prejudiced parties and by politicians. But many businessmen persist in carrying on the practices under consideration, even after they have been condemned by large sections of the press and public and by other businessmen. Then a law is proposed and some or many of the interested businessmen fight its passage, thereby placing themselves in the light of defending the condemned practices.[12] Eventually a law is passed. Clever lawyers attempt to devise means to avoid the spirit if not the letter of the law, and ultimately the courts interpret it. It may be declared unconstitutional; or the original intent may be read out of the law by the interpretations of the court. The weak points are thus found, and a new and more stringent law is passed, revised in a manner more likely to pass the constitutional or judicial test and retain the intent of the legislature.

[12] It must be recognized, of course, that some well-intentioned attempts to solve such problems have been made by businessmen, and have later been declared to be illegal, or for other reasons could not be enforced.

This is substantially the story of the development of antitrust legislation designed to control monopoly and the level of competition. Although the Sherman Act established the broad foundation for government control of monopoly and is basic to the maintenance of competition, taken alone it proved quite inadequate as a means of preventing the development of unfair competitive practices. In response to this situation the Congress in 1914 passed two acts largely concerned with standards of competition: the Clayton Act which prohibited certain practices which had escaped the Sherman Act; and the Federal Trade Commission Act which set up administrative machinery to deal with monopoly and unfair trade practice problems on a continuing basis. The effect of the two laws upon the level of competition may be considered together since the Federal Trade Commission administers its creating Act and also those sections of the Clayton Act which are particularly relevant for marketing.

Federal Legislation Dealing with the Plane of Competition

The Clayton Act. As previously pointed out, the Clayton Act in Section 2 prohibited discrimination in price between different purchasers of commodities where the effect "may be to substantially lessen competition or tend to create a monopoly." Exceptions were made when differences in price were based on differences in grade, quality, or quantity sold, made only due allowances for differences in costs of selling or transportation, or were made in good faith to meet competition in the same or different communities. The Act also in Sections 7 and 8 prohibited one corporation from buying the stock of another corporation and the use of interlocking directorates where these practices would restrain competition or tend to create a monopoly.

The Federal Trade Commission Act. While the Clayton Act was designed to supplement the Sherman Act, the Federal Trade Commission Act embodied a new approach to the problem of unfair competition. In addition to duties in connection with enforcement of the sections of the Clayton Act just enumerated,[13] the Commission was given sole responsibility for enforcing Section 5 of the Trade Commission Act which stated that "unfair methods of competition in commerce are hereby declared unlawful." The Commission was to have the function of determining what practices were unfair and then prohibiting them, subject to review by the courts. That Congress did not try to frame a statutory definition of unfair competition was

[13] These powers are shared with the Attorney General, and also include enforcement of Section 3 dealing with tying contracts and exclusive dealing arrangements which are discussed in Chap. 18.

apparently due to a feeling that it would be impossible to formulate one which would include all unfair practices. In addition the Commission was given extensive powers of investigation to be exercised on its own initiative or at the request of the President or Congress.

The Robinson-Patman Act. The effectiveness of the Federal Trade Commission and the scope of the Clayton Act with respect to the pricing aspects of marketing were considerably broadened by the passage of the Robinson-Patman Act in 1936. To accomplish this the Act declared illegal price discrimination not based on cost, condemned the direct or indirect payment of brokerage fees to purchasers, and prohibited discriminatory payments for advertising allowances or similar services to customers.[14]

The Wheeler-Lea Act. The powers and functions of the Commission itself were somewhat broadened by the Wheeler-Lea Act of 1938. There had grown a feeling that there were two major weaknesses of existing legislation. The first was that the necessity of proving that competitors were injured often meant that practices injurious to the public could not be prevented. For example, in a case which became notorious the Supreme Court refused to uphold an order to cease and desist from advertising that an obesity "cure" sold by the Raladam Company could be safely taken. The Commission had found that the product could not be safely taken without medical supervision. The Court held that, although the product might injure consumers and amount to unfair trade methods, this did not make them unfair methods of competition within the meaning of the law, since the Commission had not shown that the practice substantially injured rival competitors, who apparently used equally misleading representations.[15]

The second weakness was in the enforcement procedure which required the Commission to seek court enforcement of a cease and desist order if a respondent did not wish to abide by its rulings. The first of these two weaknesses was remedied by changing Section 5 to read "Unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce are hereby declared unlawful." In this same general connection the Commission was also given the power and duty to prevent the dissemination of false advertising of foods, drugs, cosmetics, or curative or corrective devices.[16] Enforcement provisions were strengthened by providing that any

[14] For a detailed discussion of this law and its effects on price policies see above, Chap. 28.

[15] *Federal Trade Commission* v. *Raladam Co.*, 283 U.S. 643 (1931). In a later case the Commission took great care to demonstrate the competitive effect of Raladam's practices and the Commission's order was upheld. *Federal Trade Commission* v. *Raladam Co.*, 316 U.S. 149 (1942).

[16] These latter aspects of the law are discussed in Chap. 30.

order became final after sixty days unless appealed to the courts by either party.[17]

The Anti-Merger Act of 1950. The Clayton Act restrictions upon intercorporate acquisitions of stock as a means of preventing combinations which might promote monopoly or lessen competition proved ineffective since no accompanying restriction was placed upon the acquisition of the assets of one corporation by another.[18] What could not be done one way could be accomplished the other. With the wave of mergers following World War II this loophole attracted considerable attention, bringing the Anti-Merger Act of 1950, an amendment to Section 7 of the Clayton Act. Intercorporate acquisitions are prohibited when the acquisition may have a substantial adverse effect on competition in some section of the country.

Passage of this amendment has brought renewed activity on the part of the Federal Trade Commission.[19] While time has not permitted the impact of this potentially important legislative change to be thoroughly tested, a number of actions have been brought by the government with some success. For example, *U.S.* v. *Bethlehem Steel Corporation and Youngstown Sheet and Tube Company*[20] prevented a merger of the second and sixth largest steel companies, and *U.S.* v. *Brown Shoe Company*, et al.,[21] prevented a vertical merger of a large shoe manufacturer and a large shoe distributor. It gives promise of considerable help to the government in preventing mergers which might substantially lessen competition.

Unfair Methods of Competition

Even today there is no unanimity of opinion as to just what constitutes undesirable forms of competition or what forms of control should be utilized to prevent them, and there was even less at the inception of these laws. There is little question, however, about the general principle involved; that is, some practices are not only considered to be undesirable from the point of view of the general public, but they cannot be effectively prevented by the aggrieved

[17] This improvement was true only of cases arising under the amended Section 2 of the Federal Trade Commission Act. The old procedure had to be followed for cases arising under the Clayton Act and the Robinson-Patman Act until an additional amendment in 1959 which made cease and desist orders under these laws similarly self-enforcing.

[18] An unexpected recent exception to this statement was the du Pont-General Motors case in which it was held that du Pont's acquisition of 23 per cent of the stock of General Motors, acquired some 40 years earlier, tended to create a monopoly and restrain trade. *U.S.* v. *E. I. du Pont de Nemours* et al., 353 U.S. 586 (1957).

[19] For an evaluation of the meaning of the amended section, see Federal Trade Commission, *Report on Corporate Mergers and Acquisitions* (Washington, D.C.: U.S. Government Printing Office, 1955), Chap. 6.

[20] CCH Par 69, 189 (D.C.S.N.Y., November 1958).

[21] CCH Par 69, 532 (D.C.E.Mo., November 1959). This decision is being appealed.

party. In some cases, as with "inside prices," adulterated food, or harmful drugs, he may not even know about them. When he does know, he frequently finds it impossible to prevent them, or can do so only by recourse to slow and expensive court procedure or to similar acts, which may lead to further reprisals. Such practices can be effectively eliminated, consequently, only by associative action or by governmental intervention.

Many competitive practices are clearly dishonest because they involve fraud, deception, or bad faith. Such practices may or may not injure direct competitors, but they are likely to cause injury to business and consumer purchasers. Other practices are considered undesirable because they injure competitors or discriminate among the business customers of the offending firm. Such practices prevent the full advantages to be derived from competition and may unduly restrain competition or tend toward monopoly. Although most of the practices falling in the first group are clearly dishonest and few question the desirability of preventing them, there is far less agreement concerning practices which fall in the second group. Honest men differ as to just what practices should be eliminated.

Over the course of its existence, the Federal Trade Commission has developed a considerable list of practices which it considers unfair. Probably the best indication of the nature of the acts and practices which are generally agreed to be unfair and which should be eliminated is found in the list of "cease and desist" orders of the Commission as shown in its annual reports, which now list 31 principal types, many of which have numerous subdivisions.[22]

Recent orders of the Commission include the prohibition of the following types of practices: making false and disparaging statements respecting competitors' products and business; alleging falsely that a competitor's products infringe on the company's patents and threatening to sue the competitor or his customers; buying up supplies in order to hamper competitors and stifle or eliminate competition; using concealed subsidiaries, ostensibly independent, to obtain competitive business not otherwise available; using loss leaders or giving products without charge as a deceptive or monopolistic practice or to hinder or suppress competition; coercing purchase of one product as prerequisite to purchase of another; bribing competitors' or customers' employees or agents; procuring competitors' confidential information by unfair means; and imitating or simulating trade-marks, trade names, or other distinctive characteristics of competitors' products.

Other practices falling in this classification of "unfair" trade are in the nature of "conspiracies" involving two or more firms. Such agreements which

[22] *Annual Report of the Federal Trade Commission* (Washington, D.C.: U.S. Government Printing Office, June 30, 1959), pp. 44–51, 76–9, and 85–91.

are monopolistic or tend toward monopoly have been illegal under federal statutes since the passage of the Sherman Act in 1890 and are also illegal under many state laws. Practices cited by the Commission include: trade boycotts or combinations of traders to prevent certain wholesale or retail dealers or certain classes of such dealers from procuring goods at the same terms accorded to the boycotters, or to coerce the trade policy of competitors or of manufacturers from whom they buy; compelling resale price maintenance by cooperating to compel wholesalers and retailers to maintain prices fixed by a vendor; "combinations or agreements of competitors to fix, enhance, or depress prices, maintain prices, bring about substantial uniformity in prices, or to divide territory or business, to cut off or interfere with competitors' sources of supply, or to close markets to the competitors"; and the use by trade associations of "so-called standard cost systems, price lists, or guides, or exchange of trade information calculated to bring about these ends or otherwise restrain or hinder free competition." [23]

A very large number of cease and desist orders has also been issued in connection with unfair practices involving fraud, deception, or bad faith. These include such things as: false and misleading advertising; misrepresenting materials, ingredients, durability, value, or the results to be obtained from use of the products; misrepresentation of the nature of the vending firm or its affiliations; and the use of lotteries in the sale of merchandise. These practices are most important in their effects on buyers, especially final consumers, and may or may not affect other businessmen.[24]

None of these practices confers any benefit on the public. On the other hand, they hamper the operations of competing firms that may be just as efficient or even more efficient than their dishonest or unscrupulous competitors. They illustrate some of the excesses of our competitive regime which must be eliminated if the best results are to be achieved. But such practices, though common enough, appear to be less prevalent than formerly. The improvement of business ethics and the activities of trade associations and governmental agencies have all contributed toward the elimination of undesirable practices by more or less unscrupulous firms.

Enforcement Procedure of the Federal Trade Commission

The procedure of the Commission in its handling of cases of unfair competitive practices is of considerable interest and significance. This is because

[23] It is the *result* that is important. The *use* of these devices by trade associations is not illegal in and of itself.

[24] The aspects of the Commission's work affecting primarily consumers are discussed in Chap. 30.

the ability of the Commission to curtail or eliminate unfair practices largely depends upon its fairness and effectiveness. The procedure divides into three sections—informal, formal, and judicial review.

Informal Procedure. In the majority of cases the machinery of the Commission is set in motion by informal complaints from the public, usually by a businessman who feels he is being injured by unfair practices of a competitor. The complainant is not named in the proceedings. Action may also be initiated by direct observation of radio, magazine, newspaper, and mail order advertising by the Radio and Periodical Division (set up largely to administer the Wheeler-Lea Act), or by direction of the Commission itself. A preliminary investigation is then held by the Chief Examiner's Division or by the Radio and Periodical Division to determine the legal circumstances and that the Commission has jurisdiction. Frequently cases are settled at this stage by correspondence or conference. If not, a recommendation is made to the Commission. If the Commission believes on the basis of the facts presented to it that action is necessary, it may direct the preparation of a stipulation which states the facts of the case and under which the accused party agrees to discontinue the acts which the Commission holds to be illegal.

Formal Procedure. If the accused party refuses to sign the stipulation, a formal complaint against him is issued in the name of the Commission stating the practices from which the defendant is to cease and desist. The respondent is given twenty days to file his formal answer, in which he may deny or admit the charges. If he continues to deny the charges, there is then a formal open hearing before a trial examiner of the Commission, at which evidence is filed by both parties. The trial examiner then renders a preliminary decision which automatically becomes the decision of the Commission unless the respondent asks for review by the Commission or the Commission itself wishes to review the case. When the decision is against the respondent, the Commission then orders the respondent to cease and desist from the practices charged.

Judicial Review. The orders of the Commission become final within sixty days unless within that time the defendant appeals to a United States circuit court of appeals for review of the Commission's order. Either party may appeal for review to the Supreme Court.

Although the Commission acts both as prosecutor and judge, it is evident that care is taken to see that a defendant has a full and open hearing with any decision of the Commission subject to review by the regularly constituted courts. However, relatively few cases ever get as far as judicial review, and not many require the formal procedure of the Commission. The majority of cases are settled somewhere in the process of the informal procedure of the Commission.

Federal Trade Commission Trade Practice Conferences

One of the most interesting devices developed by the Commission for the elimination of unfair practices is found in the Trade Practice Conferences.[25] They were instituted as a way of encouraging and maintaining free and fair competition in business and of assisting in relieving the Commission of the burden of overcrowded dockets. The intention is to develop rules of fair competitive conduct by conferences with the members of particular industries in the expectation that if most firms know what the rules are they will willingly conform to them. It is presumed that many, if not most, violations of the law arise from ignorance or misunderstanding. If these can be eliminated by conference, then the Commission is left only with the task of dealing with deliberate violators.

Thus these conferences establish rules of practice which will protect the trade involved and the purchasing public against unfair competitive practices. Such conferences are held at the instigation of the Commission or, more usually, upon application of any interested group or party, providing the Commission believes such a conference will be in the public interest. Reasonable public notice is given when a conference is to be held, and it is presided over by a member of the Commission or its staff. Rules for the guidance of the trade are drawn up and "such reasonable notice as to the Commission seems appropriate" is given to interested parties, "including consumers," before they are finally approved. Approved rules are promulgated by the Commission, published in the *Federal Register*, and copies are sent to known members of the trade together with a form which can be signed to signify intention of observing the rules.

The rules drawn up at such conferences cover illegal practices, practices believed to be contrary to the public interest, and "provisions for fostering and promoting practices which are designed to aid fair competition and to elevate the standards of business ethics in harmony with public policy." A special Division of Trade Practice Conferences has been established by the Commission to carry out the activities involved.

When trade practice rules are promulgated they are classified into two groups. Most of the rules are classed under Group I. These cover trade practices which are prohibited under the laws administered by the Federal Trade Commission as construed in the decisions of the Commission or the courts.

[25] See Federal Trade Commission, *Control of Unfair Competitive Practices Through Trade Practice Conference Procedure of the Federal Trade Commission*, Temporary National Economic Committee, Monograph No. 34, 1941; and *Annual Report of the Federal Trade Commission, 1959, op.cit.*, pp. 71-5.

These rules have the force of law and the Commission endeavors to enforce them. Group II rules "embrace wholly voluntary or recommended industry practices as distinguished from compulsory requirements." But a rule of this type is accepted by the Commission only when it believes it to be "in harmony with law and the public interest, and constructively in support of the maintenance of fair competitive conditions in the industry."

The specific results of the trade practice conferences are not easily determined. Group I rules cover only practices which violate the law, and no new procedure is introduced for enforcing them. But they do serve to clarify the law for the members of the trades involved and to serve as a restraining influence. And the standards of fair practice established in Group II, although voluntary and not generally enforceable by the Commission, undoubtedly have been an important influence in improving standards of business practice. The trade is helped and encouraged by the Commission to maintain desirable practices, and the Commission is able to increase the effectiveness of its efforts to eliminate unfair methods of competition.[26] On the other hand, there is the danger that the conferences may unintentionally further collusion by giving the members of the trade more convenient contacts.

Governmental Investigation of Business Practices

Because a considerable part of our important legislation dealing with business is preceded by hearings and investigations, attention should be called to this type of governmental effort. For example, the Federal Trade Commission has wide powers of investigation and can be called on for certain types of investigation by the President, either house of Congress, or the Attorney General. Over the time of its existence, the Commission has had occasion to touch upon almost all phases of industry and marketing and has published reports under more than 150 different titles comprising several hundred volumes. Among the important industries investigated have been cement, chain stores, coal, electric and gas utilities, meat packing, grain trade, newsprint, and textiles. The Commission has also investigated such matters as the consequences of basing point systems, grain futures trading,

[26] Group I rules cover practices similar to those enumerated just above. Examples of Group II rules are: the arbitration of disputes between industry members and their customers; the distribution of credit information; compliance with safety requirements; the dissemination of information concerning treatment, care, and cleaning of product; differentiation, in invoices, between width, thread count, and weight of cotton in the grey and in the finished state; the uniform closing of business offices on Saturdays and Sundays; the condemnation of the return of merchandise without just cause; the repudiation of contracts, and other practices deemed to be inconsistent with sound and ethical business methods. The *Annual Reports of the Federal Trade Commission* list trade practice rules as promulgated each year.

resale price maintenance, and stock dividends. Distribution methods and costs in a number of important areas have also been investigated. Many of these have provided the factual information upon which legislation important for manufacturing and marketing have been based. For example, the Packers and Stockyards Act came after an inquiry into the meat-packing industry, and the Robinson-Patman Act after the chain store investigation.

Other governmental agencies in their annual and special reports frequently recommend changes in legislation, usually based upon investigations which they have themselves conducted. The Congress itself makes many important investigations which, while not necessarily conducted in connection with proposed legislation, often result in legislation. Examples are the Report of the Industrial Commission in 1900, the voluminous reports of the Temporary National Economic Committee, the National Resources Committee, and the Joint Committee on the Economic Report.

On the whole the investigations have proven most valuable. They are the source of much of our information on business practices and have been an essential aspect of the formation of public policy in relation to business and marketing practices.

SUMMARY

It is evident that intervention by the government in the marketing process to prevent monopoly and to preserve competition has shown a steady increase over the years. The failure of the common law to deal adequately with business practices harmful to the public interest led first to the Sherman Act of 1890 and to the antitrust acts of most of our states. These acts were primarily intended to maintain competition by preventing monopoly. Gradually it was recognized that competition itself might lead to certain practices which were detrimental to the interests of society, however much they might promote the interests of those engaging in them, and so emphasis shifted to efforts to maintain and improve competition. This development is exemplified in the two acts passed in 1914—the Clayton Act which deals with discrimination where it lessens competition and leads to monopoly, and the Federal Trade Commission Act which is concerned with unfair methods of competition. The continuing and increasing concern with the plane of competition and with unfair methods of competition is evident in the two more recent acts in this field, the Robinson-Patman Act of 1936 and the Wheeler-Lea Act of 1938.

Thus governmental intervention to prevent monopoly and to preserve

and to control competition has greatly increased in complexity and scope. In the view of some observers this has made the program cumbersome and unwieldy to an extent which endangers the attainment of the objectives. At the same time it is important to notice the character of this intervention by the government. It has not been done by substituting the decisions of the government for those of individual businessmen. Rather the effort has been in the tradition of establishing a system of general rules which would form a framework within which the independent decisions of businessmen operating by these rules would bring about economic results which are in the public welfare.

QUESTIONS FOR DISCUSSION

1. Why has public policy in this country traditionally favored a competitive market structure?
2. What forms of governmental intervention have evolved in the effort to establish a market structure promotive of the public welfare?
3. Explain briefly the needs which brought forth each of the following federal acts: the Sherman Act, the Clayton Act, the Federal Trade Commission Act, the Robinson-Patman Act, the Wheeler-Lea Act, and the Anti-Merger Act of 1950.
4. What advantages and disadvantages do you see to the Trade Practice Conferences of the Federal Trade Commission?
5. In what ways may the power of government to investigate business practices be of significance to public policy in the regulation of business?

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30. GOVERNMENTAL RESTRICTIONS ON COMPETITION; CONSUMER PROTECTION; AND AIDS TO MARKETING EFFICIENCY

GOVERNMENTAL POLICIES RESTRICTING COMPETITION

The traditional policy of the federal government, and generally of the state governments also, has been to maintain competition and eliminate monopoly. Where monopoly has seemed desirable, as in the case of transportation and public utilities, the grant of monopoly has been accompanied by public regulation. But along with this feeling that a competitive market structure was most likely to lead to the public welfare went a counter trend. Throughout the history of antitrust legislation, there have appeared misgivings about the efficiency of competition to give the best results in particular areas of the economy. This has resulted in exemptions from the general policy of requiring competition, often to the point of contradictions in policy or actual reversals of policy. These have included various exceptions to the antitrust acts and governmental restrictions on competition in agriculture, labor, and in business. Some of the more significant of these restrictive policies will be discussed in this chapter.[1]

[1] A brief outline of some of the more important exceptions made at various times would include the following:

A. Exceptions to the Antitrust Acts
   1. Webb-Pomerene Act of 1918
   2. Transportation Act of 1920 and succeeding acts
   3. Capper-Volstead Act of 1922
   4. Cooperative Marketing Act of 1926
   5. Clayton Act (labor and agriculture sections)
   6. Norris-LaGuardia Act of 1932

(*Continued on next page*)

Governmental Restriction on Competition in Foreign Trade

From the start, of course, an important exception to the promotion of competition existed with the tariffs on imports. These interfered, often very seriously, with competition in foreign trade. Tariffs have frequently constituted important protection behind which domestic producers have been able to operate unhampered by foreign competition. The other important exemption in foreign trade resulted from the passage of the Webb-Pomerene Act of 1918. This legislation exempted from the Sherman Act associations organized for the sole purpose of engaging in export trade. Whatever arrangements were made, however, were not to be in restraint of trade in the United States and information was to be supplied to the Federal Trade Commission which it was hoped would prevent this. Actually, the supervisory role of the Commission was very limited during the first 35 years of the Act. In the last few years, however, it has begun to look more actively into compliance with the law.[2] Interestingly enough, the Act is so worded as to prevent unfair methods of competition against American competitors of such a cartel, but apparently unfair methods of competition are permissible against foreign competitors. The Act has been rather universally condemned by those favoring a competitive market on the grounds that an antimonopoly policy at home and the reverse abroad were bound to be self-defeating in important respects and sometimes in outright conflict with each other.

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7. National Labor Relations Act of 1935 and succeeding acts
8. Agricultural Marketing Agreements Act of 1937
9. Agricultural Adjustment Act of 1933 and related succeeding acts
10. National Industrial Recovery Act of 1933
11. Robinson-Patman Act of 1936
12. Miller-Tydings Act of 1937, McGuire Act of 1952, and state resale price maintenance (fair trade) acts

B. Grants of Monopoly
   1. Public utility and transportation franchises
   2. Copyrights, patents, and trade-marks
   3. Post office, public utilities, and other publicly owned monopolies

C. Other Attempts to Limit Competition
   1. State loss-limitation (unfair practices) acts
   2. Discriminatory taxation
      a. Tariffs
      b. Oleomargarine taxes
      c. Taxes favoring intrastate business
      d. Antichain store taxes
   3. Interstate trade barriers.

[2] *Annual Report of the Federal Trade Commission* (Washington, D.C.: U.S. Government Printing Office, 1959), pp. 65–6.

Governmental Restrictions on Competition in Agriculture

Farmers have long considered themselves at a disadvantage compared with the rest of the economy. By organizing for political power, they have been able to obtain a good deal of special legislation designed to further their interests by relaxing in their favor the general public policy requiring competition. The Clayton Act declared that nonprofit seeking associations of agriculturists (or laborers) should not be "held or construed to be illegal conspiracies in restraint of trade, under the anti-trust laws."

Early Legislation. With the advent of the long agricultural crisis after World War I, there began a long series of special interest acts favorable to farmers. In 1922 the Capper-Volstead Act provided that farmers could act together in associations or corporations for the purposes of collectively processing, preparing for market, handling, and marketing their produce. The associations could have marketing agencies in common along with any necessary contracts or agreements to make them effective. The associations were exempted from the Sherman Act. As a precaution against antisocial action by any of the exempted associations the Secretary of Agriculture was given the power to intervene if "such association monopolizes or restrains trade in interstate or foreign commerce to such an extent that the price of any agricultural product is unduly enhanced thereby."[3] This legislation was merely permissive. In the Cooperative Marketing Act of 1926 the government began to take an active part in sponsoring agricultural cooperatives, and a number of national organizations were organized following the passage of this Act.[4]

Agricultural Marketing Act of 1929. A very significant departure from the control of marketing by the impersonal forces of competition occurred with the passage of the Agricultural Marketing Act of 1929. This was the major effort of the Hoover administration to relieve the farmer from the low prices which had continued since World War I. It marked the first attempt in this country to plan and control a major section of the economy on a national scale. The Act provided for two main activities. One was the formation of the Federal Farm Board with a revolving fund of $500 million under which

[3] Giving this power to the Secretary of Agriculture rather than the Attorney General may not have been without purpose, since there is no record that the Secretary has ever intervened.

[4] It is interesting that this Act authorized agricultural cooperatives to exercise powers in handling statistical and other information in ways which had been denied to open-price trade associations.

a stabilization corporation was to buy and sell commodities in the open market with the intention of stabilizing their prices. The second was to encourage the federation of cooperatives in various commodity lines of production into national marketing cooperatives to whom large loans were made at low rates of interest.

The results were not successful. Too much faith was placed by the sponsors of the Act in the extent to which "orderly marketing" and holding "surpluses" off the market would be effective in raising prices. The fact was that the large volume produced at the time could not be sold at prices satisfactory to farmers, particularly with the further pressure on prices resulting from the depression. Holding surpluses off the market merely put off the evil day when they had to be sold. The Board attempted to have farmers produce less but had no effective means of controlling production and made no suggestions for alternative uses of their land. Consequently, farmers did not curtail production.

Agricultural Adjustment Act of 1933 and Succeeding Years. With the beginning of the Roosevelt administration, and under the influence of the great depression, much of the marketing legislation undertook to remove various areas of the economy from the influence of competition. In the field of agriculture the new administration introduced the Agricultural Adjustment Act of 1933. The sponsors of this Act recognized the shortcomings of the Agricultural Marketing Act, and the new Act provided means to meet more effectively some of the problems the former Act had failed to solve. In particular the various acts since then have recognized what every successful monopolist has learned—that restriction of output is a necessary condition for effective maintenance of prices.

A succession of acts, including the Agricultural Adjustment Act of 1933, the Soil Conservation and Domestic Allotment Act of 1936, and the Agricultural Adjustment Act of 1938, brought federal aid to agriculture to essentially its present situation. The objective is a goal of "parity prices," until recently defined in the Acts as "that price for the commodity which will give to the community a purchasing power with respect to articles that farmers buy equivalent to the purchasing power of such commodity in the base period August, 1909, to July, 1914," relatively a very favorable period for agriculture.

However, over-all productivity in agriculture has increased faster than in the rest of the economy so that relative costs have dropped, and prices propped at such arbitrary levels have brought forth tremendous quantities of farm goods. The over-all objective, therefore, has shifted in fact toward "income parity," and the definition of parity prices themselves is now related to a

moving average of prices of the ten years preceding the year in question. Thus the basic purpose of the farm programs has been to support farm incomes in an effort to keep the standard of living on farms rising along with that of the nonfarm population.

Essentially farm aid today consists of two programs paid for by the government. One is in the form of benefit payments made for the adoption of prescribed methods of soil conservation, including under the Soil Bank program the outright removal from production for varying periods of some lands. The larger part of farm appropriations, however, is used for a more direct subsidy of farm prices, primarily by means of nonrecourse loans to farmers in return for their agreement to reduce their acreage planted to the supported crop. Thus a cooperating farmer can borrow at whatever per cent of parity is specified at the time, say 75 per cent of the parity price, and pledge his crop for the loan. If the market price rises above the loan value, he may sell the crop, pay back the loan, and pocket the difference. If the market price falls below 75 per cent of parity, the farmer simply turns his crop over to the government in fulfillment of his debt and the loss is borne by the Department of Agriculture. Non-cooperating farmers in some crop programs may receive no price support, or a lower one, for their output. In other cases quotas are compulsory after two thirds of the eligible farmers voting on the program approve the quotas. The major portion of this part of the price support program involves wheat, corn, and cotton, but currently 17 other crops are covered.

The other portion of the support program has been one of direct market purchase. This has been used for relatively perishable farm products which could not so easily be stored such as eggs, butter, turkeys, beef, and pork. In this case the government attempts to boost market prices by removing the commodity from the market through purchases from processors or handlers. It then tries to dispose of these products through so-called noncompeting outlets such as school lunch programs, foreign aid, or poor relief. If they cannot be disposed of they are stored if possible, or they may be destroyed. Output controls have not generally been imposed under these direct purchase programs. They have been used only intermittently, on a relatively small scale, and with indifferent success.

The controls on supply under the acreage control programs have in fact not proved very successful. The reason is not that smaller supplies would not have raised prices and incomes. With inelastic demand for most agricultural products they would. The difficulty has been that the programs have not been sufficiently successful in restricting output. For one thing, farmers usually take their least productive land out of cultivation. More important

has been the remarkably rapid increase in productivity in agriculture. Better fertilizer and land use methods, improved strains of plants and hybrid seed corn, and better equipment have all worked in the direction of maintaining output. In addition farmers have often used the land released from restricted crops to grow others such as soybeans and grain sorghums which compete in part with the restricted crops. Thus even though price supports have gradually been lowered, surpluses at the fixed prices have continued to build up. Over the last decade the government has bought up (mainly through the non-recourse loans) nearly one third of the wheat production and during the late fifties almost one half of the cotton crop.

Agricultural Marketing Agreements Act of 1937. One other piece of legislation is interesting in indicating the degree to which competition has been restricted in the marketing of agricultural products. This is the Agricultural Marketing Agreements Act of 1937. The Act has been widely used in the marketing of fluid milk and commercial fruits and vegetables. The Secretary of Agriculture is permitted "to enter into marketing agreements with processors, producers, associations of producers, and others engaged in the handling of any agricultural commodity or product thereof. . . . The making of any such agreement shall not be held in violation of any of the anti-trust laws of the United States." Such agreements become binding on all producers or handlers of the commodity if it is approved by two thirds of the producers. In the various agreements which have been executed, methods have been devised to limit the total quantity of a commodity which may be marketed; to allocate the amount which each handler may purchase from producers and the amount which he may market; to determine the size of any surplus and what shall be done with it; and to establish pools for any commodity, and determine the distribution of the net return from their sale.

It is evident from this description of the intervention of government in agriculture that a large segment of the American economy has been removed from the sphere of competitive activity. While these production and marketing controls are not in operation at all times for all farm products, they stand ready at any time for imposition when the forces of the market and competition threaten the price structure of agricultural products. Thus a large part of the economy has been legally cartelized and made subject to government planning and control.

Governmental Restrictions on Competition in Business

Exceptions from the competitive market structure in the production and marketing of manufactured products by government action have not been

so generally made. Nevertheless some important departures have occurred, some temporary and some of long standing.

Restrictions on Competition by Means of Patents. The patent system seems to be an essential part of a private enterprise system since it protects the inventor from having the benefits of his efforts appropriated by others. The patent laws, as distinguished from the patent system, have been subject to serious criticism, however.[5] While the objective of these laws is, of course, to give a limited monopoly on the process involved, it is held that the present patent laws have operated to enhance the very type of monopoly which the antitrust laws were designed to prevent. The courts have ruled that the granting of a patent does not exempt the holder from the antitrust laws, but in practice it has proved very difficult to draw the line as to where the rights granted by patent law end and the limits prescribed by antitrust law begin. Thus firms already in a powerful legal and financial position may be able to prevent others from entering the field by withholding the use of patents, or by threatening holders of related patents with infringement suits and endless litigation, or several firms may pool their resources by cross-licensing arrangements and combine to prevent outsiders from entering. Patents may be used in attempts to control marketing arrangements by prescribing the quantity that licensees may produce, the territories in which they may sell, the customers to whom they may sell, or by requiring them to buy unpatented products as a condition to the purchase of patented products, and similar practices.

Restrictions on Competition under the National Recovery Act of 1933. During the depression of the thirties the government took the initiative in industry, as it had in agriculture, in removing many restrictions on monopoly practices. Among the acts affecting marketing during this period were the Miller-Tydings Act, the Robinson-Patman Act, the Bituminous Coal Commission Act, the Petroleum Conservation Act, the Sugar Control Act, and the National Industrial Recovery Act.

The National Industrial Recovery Act of 1933 was the outcome of a rather complicated political bargain by which important rights were granted to organized labor in return for substantial rights of business self-government. Under the law, industries were to establish code authorities—usually an

[5] See *Patents and Free Enterprise,* Temporary National Economic Committee, Monograph No. 31, 1941; Corwin D. Edwards, *Maintaining Competition* (New York: McGraw-Hill, 1949), Chap. 6; *Anti-Trust Problems in the Exploitation of Patents,* Subcommittee of the Judiciary, House of Representatives, 84th Congress, 2nd Sess. (Washington, D.C.: U.S. Government Printing Office, 1957); and Floyd L. Vaughan, *The United States Patent System* (Norman: University of Oklahoma Press, 1956).

existing or newly constituted trade association—which was to write a "code of fair competition" to prescribe minimum wages, prices, and standards of competition for the industry. The Act specifically provided that actions taken under the codes "shall be exempt from the provisions of the anti-trust laws of the United States," although the codes had to be approved by the administrator of the Act, and elaborate arrangements were made to enforce compliance. Before the Act was declared unconstitutional in 1935, some seven hundred codes had been established. Many of these organizations saw an opportunity to solve some of their marketing problems and wrote into the codes provisions designed to establish minimum prices or prevent price cutting. These were often linked with prohibitions against sales below cost, controls on output and even sometimes on the creation of added productive capacity, and the prevention of misleading advertising and other practices considered to be unfair methods of competition.

The ideas embodied in the National Recovery Act have had a relatively long history in connection with the idea of self-government by business in the public interest. Many industries at one time or another have complained that competition in their field was excessive, cutthroat, or destructive and must be regulated if the public interest in a healthy industry is to be met. The basic approach of the antitrust laws had been to prevent self-government by business for fear that it would result in monopolistic action, and when the laws were relaxed under the NRA it became evident that the fears were well founded. Perhaps the major lesson of this remarkable episode is that it is very easy to identify one's own business self-interest with the public interest.

Modifications of the Antitrust Laws. It has already been pointed out that the field of agriculture has been removed from the limitations of the antitrust laws in many respects. Two modifications largely affecting marketing by business have also been made to these laws in the Robinson-Patman Act of 1936 and the Miller-Tydings Act of 1937.[6] The Robinson-Patman Act is an amendment to the Clayton Act designed to strengthen the prohibitions on price discrimination. While the effects of this law on the whole may be to improve the plane of competition, it does tend to prevent many practices which were formerly considered the natural and legitimate outcome of competition. The Miller-Tydings Act, and the subsequent McGuire Act of 1952, exempted from the antitrust laws contracts for resale price maintenance in interstate trade where price maintenance was permissible within the states

[6] These two Acts may also be considered as representing in some degree an attempt to carry on that part of the National Recovery Act which regulated trade practices and unfair competition.

concerned. The law resulted in a considerable increase in the use of resale price maintenance.[7]

Under the Small Business Acts of 1953 and 1958 cooperation among small businesses for various purposes is authorized and given antitrust immunity if approved by the Attorney General. Thus such firms may set up corporations to obtain raw materials and equipment cooperatively or they may join together to undertake research or to exploit patents. Likewise collective arrangements among small businesses contributing to national defense are exempted.

Limitations on Competition by the States. During the depression period of the thirties, several movements arose in the states to protect some areas of business from what was regarded as too severe competition. These included the loss-limitation laws and resale price maintenance laws previously discussed in Chapter 28 and the antichain store taxes treated in Chapter 12. More recently a few cities have tried to penalize supermarkets with heavy taxes. Many states have also enacted antidiscrimination laws similar to the Robinson-Patman Act.

In addition numerous laws have been passed creating barriers to interstate trade. It has often been remarked that an important reason for the great industrial development of the United States is the fact that we have the "greatest free-trade market area in the world." This has resulted from the provision of the federal Constitution which provides that "No state shall, without the consent of the Congress, lay any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws." Unfortunately many states take advantage of the second part of this clause to introduce barriers to interstate trade which hamper this freedom of commerce among the states. The continued imposition of trade barriers could ultimately make large-scale production and regional specialization on the present scale impossible. While such an extreme result is unlikely, many businessmen have already found their operations severely hampered by such legislation.

Most important in restraining trade between the states has been the use of the taxing power and the police power. Laws regulating and taxing commercial motor vehicles appear to present the greatest barriers to interstate trade. The imposition of taxes on trucks that enter a state is a common device. Such taxes are frequently very high and usually increase rapidly with the size of the truck. Other states require interstate truckers to pay mileage taxes instead of registration fees, and these are often higher than the tax

[7] Both of these laws, along with judicial and legislative developments, are discussed in detail in Chap. 28.

on intrastate trucks. Most of the states place limitations on the dimensions and weight of motor vehicles. Another device instituted by a number of states is the port of entry at which vehicles are inspected for the payment of fees, special mileage and gasoline taxes, equipment, weight, size restrictions, and insurance.

The need of the states for added revenues has also led many of them to stretch as far as possible the application of their corporation income taxes to out-of-state corporations which merely solicit orders within the state without maintaining offices, plants, or warehouses within the state.[8] Such extensions were approved by the Supreme Court in 1959.[9]

This imposed a burden on interstate commerce for two main reasons, both of which were stressed by Justice Frankfurter in his minority opinion. First, to meet the diverse requirements of, potentially, as many as 50 states, all with different rules, regulations, and formulas for taxing, will mean large increases in costs for bookkeeping, accounting, and legal advice. This added cost might well be more than the cost of the taxes themselves and be enough to force many businesses, especially small and medium-sized firms, out of interstate commerce. Second, the effort of each state to devise formulas which will maximize its share of the available revenue may well involve taxation on more than 100 per cent of income, and together with the costs of litigation bound to arise, constitute a further burden on interstate commerce.

The decisions created great concern among businessmen and others. As a result legislation has been passed by the Congress to alleviate the situation by excluding from such taxation income earned from the sale of goods by traveling salesmen or by independent brokers when title is transferred and the sale consummated in another state. The Congress also established a commission to examine the situation further and to prepare legislation requiring uniform standards which the states must observe in imposing income taxes upon businesses engaged in interstate commerce.[10]

The potential significance of this action should not be underestimated. While the Constitution gives the Congress the power to regulate commerce among the states, it has never exercised this power in regard to the taxation of interstate commerce (except for two acts immediately following the Civil War). The action raises the possibility of further federal action in this vital area.

[8] Paul Studenski, "State Taxes Threaten U.S. Common Market," *Harvard Business Review*, July–August 1960, pp. 61–3.

[9] *U.S. Supreme Court Decisions*, Nos. 12 and 33, October Term, 1958, February 24, 1959.

[10] Select Committee on Small Business, U.S. Senate, *State Taxation of Interstate Commerce*, Hearings, Parts 1, 2, and 3, April 8 to June 19, 1959.

Most of the states and many counties and cities provide for inspection of fluid milk, several requiring inspection of the source of supply; and in a number of states administrative officials are empowered to regulate the milk supply, determine milk sheds and marketing areas, and fix milk prices. Many of these regulations are necessary health measures, but it seems evident that they are sometimes arbitrarily enforced and cause unnecessary difficulties to out-of-state producers and shippers. Until recent years, many states placed restrictions on the sale of oleomargarine for the purpose of protecting state dairy interests and a few still do. These include the imposition of prohibitive taxes, labeling provisions, and attempts to limit ingredients to state products. In some states, for example, oleomargarine made from domestic crops pays reduced taxes or is exempt from taxes. The varied labeling provisions of the several states also introduce confusing elements in the interstate traffic in this product.

In the interest of health, a number of states require certificates, permits, and notices of shipment of one kind or another from the states from which livestock is received, and sometimes a further inspection is required in the state of destination. Several states have grading laws which favor home-grown food products. For example, some state regulations make it impossible for any but home-produced eggs to be labeled as "fresh." State laws regulating standards, labeling, packaging, and grading of food products vary between the states and, again, frequently favor the home product and add greatly to the difficulty of marketing. Some states have "state of origin" labeling requirements designed to foster the use of domestic products. Embargo laws of various types are also found which are designed to protect the home market for fruits and vegetables. These are sometimes enacted to prevent certain diseases or insects from coming into the state, but are often used primarily or in part for protection of home products.

Ports of entry are also often used for inspection of plants, fruits, and vegetables, and the enforcement of embargoes thereon. A very large number of rules and regulations affecting interstate transportation of nursery stock are in effect. All states have quarantine laws designed for protection against insects and plant diseases. Rules of inspection are often very strict, and over half the states require license fees for doing business within a state. Bonds must be filed in some states, and a number give quarantine powers to administrative officials which, it is alleged, are often used to protect local interests.

Under the twenty-first amendment to the federal Constitution, the states are free to discriminate against alcoholic beverages from other states; and a state may embargo alcoholic beverages from other states that discriminate

against its own. Over half the states levy lower license fees on manufacturers of alcoholic beverages who use home-grown products; some states allow lower taxes on such beverages when they are exported to other states; and several impose restrictions on imported beverages in one way or another.

Many states have passed laws providing that preference shall be given to state-produced supplies and building materials when used in state institutions and public works. Sometimes these apply only to specific products such as coal, certain types of building stone, and textbooks. A few states restrict or prohibit the export of hydroelectric power as a means of forcing manufacturers desiring to use the power to locate in the state. A number of states and municipalities offer special inducements, such as tax exemption, to bring new industries into the state or local community, and direct aid is sometimes offered. Municipal ordinances often have the effect and are frequently designed to hamper or prevent the use of certain materials which come from outside the state. Finally, firms incorporated in other states are frequently subject to discriminatory taxes.

It is evident that many of these laws are passed for entirely legitimate purposes. In such instances reasonable objections can be raised only because they are sometimes improperly devised and place an unnecessary burden on both state and interstate business, or because they vary so from state to state that it is difficult to keep track of them and to operate in a manner which meets the requirements of all the states in which a business is carried on. Other laws are ostensibly legitimate in character but are made more stringent than is necessary to carry out the avowed purpose. Yet others are frankly intended to discriminate in favor of local industries. All such laws interfere with the freedom of trade between the states and so hinder the most efficient development of industry and trade. Potentially these laws represent a serious threat to our economic standards of living and political unity. The main difficulties in correcting the situation are, first, to determine what barriers are necessary and desirable because the good results offset the limitations they place on free trade and, second, to make sure that only such barriers remain in force. The former is difficult to determine, but the latter is far more difficult to achieve.

GOVERNMENTAL EFFORTS TO PROTECT THE CONSUMER

At least passing recognition is given by most persons to the idea that the fundamental purpose of an economic system is to supply goods and services to consumers. The test of its adequacy is its ability to meet the demands

and needs of the final consumer in the most efficient and economical way. Adam Smith, for example, said in *The Wealth of Nations* that "Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer." [11] Ideally competition is expected in our economy to lead businessmen to vie with one another to produce the goods which consumers want in the correct quantity and quality and at the least cost. Competition does seem to have this beneficent effect, but as pointed out in the previous chapter, continuous effort is necessary both to prevent monopolies and restraints of trade and to keep competition within the range of activity which will in fact benefit the public.

Even these efforts have not been thought adequate in all cases to give the consuming public all the protection it needs. One additional type of protection which has been thought necessary is direct protection to the consumer as a buyer. This consists of laws to prevent such things as adulteration, fraud, misrepresentation, and the sale of products harmful to health, and the establishment and enforcement of standards.

Early Acts and Incidental Protection

Prior to the thirties there was little federal legislation designed to protect consumers. Until that time the major reliance was to depend upon the results of government efforts to promote competition. In 1906 two laws were passed which afforded some consumer protection, the Pure Food and Drug Act and the Meat Inspection Act. While they were occasionally amended in part, there were no more federal laws specifically enacted for consumer protection during this period. However, some aids developed out of the activities of various governmental departments.

The Post Office Department has long prohibited the use of the mails in selling fraudulent goods. This has occasionally been useful, but of course the Department is not organized primarily to prevent such sales and these activities have been almost incidental.

The Bureau of Standards was established in 1901. In the present connection its duties are to define weights and measures and set the standards for them. The enforcement of these standards is left to the states and municipalities. In recent years it has worked closely with the Federal Trade Commission to test products for conformity with advertising claims.

[11] Adam Smith, *The Wealth of Nations*, Cannan's ed. (London: Methuen, 1904), Vol. II, p. 159.

The United States Department of Agriculture

The Department of Agriculture carries on a number of activities designed at least in part for the protection of consumers. The Institute of Home Economics of the Department of Agriculture, while primarily concerned with such matters as methods of preparing food and with dietary requirements, attempts to aid in the protection of the consumer by publishing buying guides which show important points to look for in clothing or food, and by studies of family budget problems. The Meat Inspection Division administers one of the oldest consumer protection acts, the Meat Inspection Act of 1906, and related Acts. The Division inspects all meat animals and meats which enter interstate commerce.[12] Inspection for disease occurs in transit, at the packing houses before slaughter, and again after slaughter. In addition, packing houses and storage houses are inspected for sanitary conditions. A voluntary grading service for meat is also available to packers requesting it.

Under the Agricultural Marketing Service, the Department has also established standards for many products, including grades for canned goods bought by consumers. These standards are voluntary, however, and with some exceptions such as The Great Atlantic & Pacific Tea Company and many consumer cooperatives, have not been widely used, except that substandard products must by law be so labeled.

Federal Food, Drug and Cosmetic Act of 1938

Perhaps the most important area in which the federal government has intervened for the protection of the public is that covered by the federal Food, Drug and Cosmetic Act. The purpose of the original Act of 1906 was to prohibit shipments of adulterated or misbranded foods and drugs in interstate commerce. It seems to have been reasonably satisfactory at the time it was passed. But with the passage of time more and more foods were sold in packages, new drugs were introduced which were dangerous unless properly administered, extravagant curative claims for worthless and harmful drugs continued and even increased, and the use of cosmetics, some of which were definitely harmful, increased. Administrative difficulties also developed in the enforcement of the original Act. Under these circumstances the demand for revision and for expansion of the scope of the Act became increasingly strong. The federal Food, Drug and Cosmetic Act of 1938 and the closely

[12] Much meat does not enter interstate commerce.

related Wheeler-Lea Act passed at the same time were in a sense the culmination in the public sphere of a strong "consumer movement" which came to a head in the middle thirties.[13]

The new Act, passed in 1938, defines drugs more broadly than did the original Act; includes therapeutic devices and cosmetics, except soap; and, in its adulteration and misbranding sections, covers many products that were not covered under the old law. Interstate traffic in adulterated or misbranded products subject to the law, in poisonous articles, in cosmetics which are harmful when used as prescribed on the label, and in food which may be injurious to health is prohibited. There are some exceptions, but in general these prohibitions are rather sweeping and spelled out in considerable detail, although in practice there still remain considerable administrative difficulties. There are also positive requirements. The administrator of the Act, for example, is authorized to set minimum standards of quality and fill of container for most packaged foods. Imitations and substandard products must be labeled as such. Standards of identity are also to be established to which foods must conform if sold under the common name for such foods; if no standards have been provided, the ingredients must be shown on the label. Artificial coloring, except in butter, cheese, and ice cream, and artificial flavoring and chemical preservatives in food must also be indicated on the label.

An amendment of major importance was the Food Additives Act of 1958. Under this law firms proposing to use new additives must pretest them, showing to the satisfaction of the Food and Drug Administration that the chemicals will be safe in the amounts and under the conditions of intended use.

The requirements for labeling drugs are even more stringent than those for foods. Variations from official standards of the United States Pharmacopoeia and the presence of habit-forming drugs must be shown on labels; active ingredients of nonofficial drugs must be listed; and, as with foods, the net weight must be shown. Control is also exercised over all printed material on containers and wrappers or enclosed in the container or shipped with it, or with articles "held for sale after shipment or delivery in interstate commerce." In the case of drugs, adequate directions for use must also accompany the product, and warning must be given against probable misuse. All the required information must be shown on the labeling in a form easily noticed and readily understood. Finally, new drugs can be sold in interstate commerce only after permission is received from the Food and Drug Administration.

[13] See Chap. 7 for a discussion of the consumer movement and its contribution to the passage of the Act.

This Act, like many others, was a compromise. On one side were the old Food and Drug Administration and several "consumer groups" who wanted broader, more stringent legislation; and opposed were many manufacturers whose opposition ranged from objecting to any change in the old Act to objection to certain provisions.[14]

That the new legislation is a great improvement on the old law seems evident. Enforcement has been much more successful both because the law itself is more comprehensive than its predecessor, and because the enforcement provisions are better conceived. In particular the injunction can now be used to enforce prohibitions, whereas formerly it was necessary to resort to the slow, relatively ineffective, and more expensive method of seizing interstate shipments of prohibited goods. Some critics of the earlier law also believe that the shift of the administration of the Act from the Department of Agriculture to the Federal Security Agency may have improved administration. The reasoning is that control over foods, and over poisonous spray residue on fruits and vegetables in particular, is more effectively carried on under an agency which is not interested primarily in the production and sale of farm products.[15]

The Wheeler-Lea Act of 1938

Closely related to the federal Food, Drug and Cosmetic Act are certain sections of the Wheeler-Lea amendment to the Federal Trade Commission Act. These give the Commission authority to prohibit false advertising, other than labeling, of food, drugs, cosmetics, and therapeutic devices. Labeling is omitted because it is under the jurisdiction of the Food and Drug Administration.

A "false advertisement" is defined in the law as one which is "misleading in any material respect," and an advertisement may be "misleading" not

[14] Businessmen quite generally, and quite naturally, oppose any restrictions on their own activities. The following statement is interesting as bearing on a common attitude toward government officials. It is particularly interesting in its bearing on this Act and on the Wheeler-Lea Act.

"Government employees have long been engaged in broadly valuable and necessary social and economic tasks. Why they should have incurred the animus of people who had no distaste for those who worked in private industry writing false advertising, manufacturing frauds, marketing worthless securities at forced prices, selling useless equipment or faulty machines, it is difficult to say. Such workers were far greater parasites upon the public purse than government employees. At least no inefficient government clerk made and sold a dangerous cosmetic containing rat poison." T. Swann Harding, "Our Federal Civil Service," *Harvard Business Review*, January 1935, p. 164.

[15] The Food and Drug Administration administers, in addition to the federal Food, Drug and Cosmetic Act, the related Tea Importation Act, Import Milk Act, Caustic Poison Act, and the Filled Milk Act. Further information may be obtained from the Annual Reports of the agency.

only as to representations "made or suggested by statement, word, design, device, sound, or any combination thereof," but also if it fails to reveal facts with respect to consequences which may result from the use of the commodity "under the conditions presented in said advertisement, or under such conditions as are customary or usual." Thus advertisers may be guilty not only for sins of commission but also for sins of omission. To disseminate a false advertisement is declared to be an "unfair or deceptive act or practice in commerce." Moreover, if the Commission has reason to believe that anyone is intending to use false advertisements of a food, drug, device, or cosmetic, the Commission is empowered to bring an injunction suit in the appropriate district court to prevent the action. Finally, if the false advertisement may result in a use of the commodity advertised which is injurious to health, or if there is an intent to defraud or mislead, the Commission may certify the facts to the Attorney General for prosecution.

This part of the amended Federal Trade Commission Act obviously ties in closely with the objectives of the Food, Drug and Cosmetic Act, and many persons advocated its administration by the Food and Drug Administration. On the other hand, the Federal Trade Commission had been attempting to control certain types of advertising in its efforts to eliminate unfair methods of competition and desired to administer all legislation against fraudulent advertising. It is a question whether the separate efforts of two governmental agencies, one dealing with labeling and one with all advertising except labeling, can be as effective as would one agency covering all labeling and advertising of the products enumerated in the two laws.

The Federal Trade Commission has proceeded with the administration of the provisions of the Wheeler-Lea Act rather vigorously by means of a number of stipulations and cease and desist orders. In fact, the Commission has stated that, "From a numerical standpoint, deceptive practices account for the largest percentage of the Commission's work."[16] The requirement that an advertisement be misleading in a "material" respect may ultimately prove to be restrictive of the effectiveness of the law if the courts should prove inclined to be restrictive in their interpretation of the wording. However, so far businessmen have shown little inclination to disagree with the opinions of the Commission on what constitutes false or misleading advertising. Most of the interpretation of the law has been built upon stipulations in which the firms concerned have agreed voluntarily to cease and desist from the unlawful practices concerned. Thus the courts have had relatively few occasions to pass upon the law.

[16] *Annual Report of the Federal Trade Commission* (Washington, D.C.: U.S. Government Printing Office, 1956), p. 37.

Since the passage of the Wheeler-Lea Act, the Commission's activities in the field of advertising seem to have gradually brought about some improvement in the content of advertising, particularly written advertising. Writers of copy in the fields explicitly covered by the Act are more careful not to make claims which cannot be supported by satisfactory evidence, and not to leave out aspects of the product which are relevant to its proper use. In fields not specifically covered by the wording of the Act it is less clear how far the jurisdiction of the Commission extends and the effects are less noticeable.[17] Television in particular has created difficulties since the picture may give an implication not specifically claimed in the spoken commercial, but which may in fact constitute the major impact of the total advertisement—e.g., an announcer may don a white coat and deliver his spiel in what appears to be a physician's office, but still make no specific claim to be a physician and no specifically untruthful claim about the product.[18]

Special Product Acts

The Federal Trade Commission administers several acts aimed at misleading, deceptive, or dangerous practices in the sale of textile and fur products.[19] The Wool Products Labeling Act of 1939 was passed to meet a chaotic situation in the industry in which "descriptive" labels used in the industry to describe the content and type of wool had come to have little relation to reality. Misleading practices commonly included such things as selling products containing reused wool as new wool, claiming that part wool products were "all wool," and that products with no wool except thread for stitching button holes were "part wool." The law authorizes the Commission to require manufacturers to use factual labels showing the per cent of wool and other fibers used and whether the wool is virgin, reprocessed, or reused. The Textile Fiber Products Identification Act of 1958 essentially extends the requirements of the Wool Products Labeling Act to other fibers, while the Fur Products Labeling Act of 1951 is designed to prevent misrepresentation and deceptive practices in the fur industry. Finally, the Flammable Fabrics Act of 1953 is intended to protect the public from hazards growing out of the sale of highly flammable clothing.

[17] See William F. Brown, "The Federal Trade Commission and False Advertising," *Journal of Marketing*, July 1947, pp. 38–46, and October 1947, pp. 193–201; and "Federal Laws Affecting Advertising—An Up-to-Date Review," *Printers' Ink Advertisers' Annual, 1955* (New York: Printers' Ink Publishing Company, 1955), pp. 474–6.

[18] A number of interesting examples are found in House Committee on Government Operations, *Reports on False and Misleading Advertising*, 85th Congress, 2nd Sess., 1958, House Report Nos. 1372, 2553, 2667, and 2668.

[19] For a fuller discussion of these Acts see Chap. 7.

State and Local Laws Protecting the Consumer

Direct protection of consumers by state and local governments is relatively limited. Perhaps the most widespread activity carried on by the states is the enforcement of standards of weights and measures. While it is the responsibility of the federal government to establish these standards, enforcement is left entirely to the states. In about equal numbers the states sometimes do it themselves, sometimes in cooperation with local governments, and sometimes enforcement is delegated entirely to the localities.

Another widespread activity of the states in the protection of the public is the adoption by most of the states of legislation controlling intrastate advertising. The majority of these states have adopted the model law written and promoted by the advertising magazine *Printers' Ink* in 1911 or modifications of that law. In general these laws prohibit statements which are untrue, deceptive, or misleading. These laws apply mainly to local newspapers and radio stations.[20]

Some states administer sanitary and health codes. These laws establish the conditions under which perishable products, such as dairy products, meats, and bakery goods, and products directly affecting health, such as drugs, may be marketed in the state. Municipal activities are numerous in total, but examples of most types of protection offered by cities are rather scattered. The main exception to this is the sanitary code. Like state legislation on this subject, the codes deal with the conditions under which perishable products and drugs may be marketed. Mention should also be made of New York City's Consumers' Service Division of the Department of Public Markets, Weights, and Measures. This bureau actively disseminates information to housewives of food bargains and similar items.

GOVERNMENTAL EFFORTS TO INCREASE MARKETING EFFICIENCY

Another aspect of the feeling that competition alone cannot bring the best results for the public is the action of government in trying to increase the efficiency of the marketing process. These include various requirements and services such as the establishment and enforcement of standards, financial assistance, research, information, inspection, and regulative activities. The justification for these activities is that they assist the marketing process to

[20] See "PI's Truth in Advertising Law 40 Years Old Today," *Printers' Ink*, November 16, 1951, p. 46, which includes the story of the development of the law together with the complete text.

bring goods to the final consumer at a lower cost than would be the case with unaided competition.

Like all aspects of the relationship of government to marketing, governmental efforts to increase marketing efficiency have undergone a gradual increase over time. These efforts are designed to reduce the cost of marketing by increasing the technical efficiency with which it is carried on. They do this by providing those standards, information, and regulation necessary to effective marketing which the unaided competitive system could not be expected to supply for itself. Fundamentally they are all intended to further the effectiveness of the competitive system in supplying the goods and services demanded by the public.

Many of these activities have been described in previous chapters. It is not always possible to distinguish between efforts that promote efficiency in marketing, or other aids to business, and those designed to control marketing operations. Activities designed primarily to control business operations may also promote efficiency and those designed to promote efficiency, often of necessity, involve control. This overlapping of objectives will be evident as the discussion proceeds.

Commonly Accepted Activities

Much governmental effort designed to promote marketing efficiency is now largely taken for granted. It is evident that many of these activities are also at least partially regulative, and that sometimes regulation is the chief objective. Laws covering the rights of private property, the law of contracts, sales, and negotiable instruments, the privilege of incorporation, monetary and banking systems, the control of weights and measures, patent, copyright, and trade-mark regulations, and the regulation of public utilities, for example, fall into this class.

Establishment of Commodity Standards

The establishment of commodity standards in various fields has been one of the most important areas of government intervention to aid the marketing process. The topic has been discussed extensively in Chapter 25. In addition to the direct aids to standardization there considered, the federal government aids the private standardization of products through the registration of trade-marks at the Patent Office of the Department of Commerce. These assist firms to market their products by having the trade-mark asso-

ciated in the consumers' mind with a given standard of quality and service. In addition the Lanham Act of 1946 administered by the Federal Trade Commission provides for the registration and legal protection of trade-marks.

Federal Regulation of Commodity Exchanges

The standardization of commodities is an obvious aid to the effective functioning of the commodity exchanges. In addition the federal government has stepped into the direct regulation of a number of the major commodity exchanges. This began with the Cotton Futures Act of 1916 which provided for federal classification of all cotton intended for delivery on future contracts, and the Grain Futures Act of 1922 to discourage price manipulation and corners. These Acts were amended several times and finally brought together under the Commodity Exchange Act of 1936. This Act, administered by the Commodity Exchange Authority of the Department of Agriculture, increased the jurisdiction to the supervision of the trading on 16 so-called contract markets now covering such products as wheat, corn, cotton, and some 20 others. The Authority also acts to prevent price manipulation and the dissemination of false and misleading crop and market information, to protect hedgers and other users of the futures markets against fraud and manipulative practices, to provide information to the public on trading operations, and to insure membership privileges on commodity exchanges to co-operative associations.

In addition the Agricultural Marketing Service administers three other acts giving important assistance and regulation to the marketing of agricultural products. The Packers and Stockyards Act (1921) authorizes the establishment of reasonable and nondiscriminatory practices among the companies which operate stockyards at terminal markets. The Perishable Agricultural Commodities Act (1930) regulates the services of brokers and commission merchants handling perishable farm products. It prohibits such things as fraudulent charges; unjustified rejection or failure to deliver; discarding, dumping, or destroying products without reasonable cause; making for a fraudulent purpose any false or misleading statement concerning condition, quality, quantity, disposition, or market conditions; and tampering in any way with the report of a federal or state inspection. Finally, the United States Warehouse Act (1916) fixes the conditions under which licensed warehouses must handle specified farm products. Commodities stored must meet federal grading standards, and the Act provides for the enforcement of proper storage, frequent inspections, and careful control of the use of warehouse receipts.

Government Research in Marketing and Marketing Statistics

The research and statistical services of the federal government have developed enormously in recent years.[21] Private agencies have done much in this area. Nevertheless, the government can perform many services of this type more effectively because it has more adequate financial resources and because government agencies are sometimes given the legal authority to collect information from private firms. Even where no legal authority is available, businessmen will often give information to the government which they would not give to a private agency because of the confidential manner in which the information is handled and firm identity is concealed.[22]

Two other important sources of information on the marketing of manufactured products may be mentioned. The Board of Governors of the Federal Reserve System publishes data on department store sales and inventories, and statistics on the credit operations of various types of stores and on instalment credit and the extension of consumer credit by banks and other financial institutions. The Bureau of Labor Statistics of the Department of Labor collects information on employment, price trends, and costs and standards of living.

Financial and Direct Assistance to Marketing

Financial assistance and direct assistance to those engaged in marketing have been particularly prominent in the field of agriculture. For example, the various activities of the Agricultural Adjustment Administration and its successor agencies have at least intended to assist in the marketing of farm products. Whether they tend on balance to increase marketing efficiency is at least questionable. The Farm Credit Administration has the broad aim of a complete and coordinated system of credit for agriculture, including farmers and their cooperative marketing, purchasing, and business service organizations. Among its activities which are particularly relevant to marketing are the Federal Intermediate Credit Banks which make loans to or rediscount paper for institutions (both government sponsored and private) which finance the marketing of crops or livestock, and the Banks for Cooperatives which loan to farmers' cooperative marketing, purchasing, and business service asso-

[21] Certain aspects of the supply of market information in particular are considered in detail in Chap. 24.

[22] An extreme example of this occurred during World War II when a government agency reported price indexes which showed the effect of black market prices. The Office of Price Administration wished to obtain the names of the firms breaking the law but was refused on the grounds that this would violate the confidence of the firms involved.

ciations. Again, the Farmer Cooperative Service also gives direct assistance to farmer cooperatives. It conducts research studies and service activities relating to problems of management, organization, merchandising, costs, and sales; confers and advises with the officers of these associations; and actively disseminates information on cooperative principles and practices.

Another field of direct assistance is the publication by government agencies of pamphlets advising persons in both agriculture and business of superior methods of marketing. The Departments of Agriculture and Commerce have been particularly active in this field. Much "how-to-do-it" information on various retail and service lines has been published by the Small Business Administration. It also provides financial assistance under certain conditions to small businesses which are unable to obtain needed funds from private sources. In addition it charters and makes loans to small-business investment companies. Likewise, the State Department and Department of Commerce and Department of Agriculture have all been active in assisting businessmen to market their products abroad.

State and Local Assistance to Marketing

State, and particularly local, assistance to the marketing of manufactured products has been relatively limited. All of the commercially important states have passed the Uniform Warehouse Receipts Law which governs the nature and form of receipts issued by public warehouses to their customers. It fixes the rights and obligations of the warehouser and the customer and also increases the negotiability of warehouse receipts. The usefulness of enforcement of standards of weights and measures, and of sanitary codes has already been discussed in this chapter. States and local governments also aid in establishing standards for many classes of business and professional men through their licensing activities. These include licensing of dealers in liquor and tobacco products, pharmacists, barbers, beauty parlor operators, cold storage warehouses, and dealers in dairy products. Many cities have also undertaken to establish local markets for important commodities or to provide better locations and improved facilities. In addition many state universities have established bureaus of business research. These have gathered statistical data and made studies relevant to marketing problems within their states and have often acted as consultants to businessmen.

The states have been most active in assisting in the marketing of agricultural products. Many states have established departments of marketing or agriculture, and through agricultural experiment stations and schools of agriculture at the state land grant universities have extended substantial

assistance to farmers and others concerned with marketing farm products. Many states have also passed special incorporation statutes authorizing farmer cooperatives to incorporate, using the basic cooperative principles which, under many regular state incorporation acts, are illegal.

There is no general agreement on the limits to which the state may properly go in its efforts to carry on activities to assist in making business operations more efficient. This type of activity is in the tradition of our competitive economy since it is designed to make the economy more efficient in performing its functions. Presumably this would suggest a cost criterion for the limits. If the government can for one reason or another supply assistance to business more cheaply than business could supply that service to itself, then it is a proper activity of government. This criterion is easier to state than to administer. All that can safely be said is that many of these activities are necessary to the smooth functioning of business operations, and that they are most likely to increase in scope as time goes on.

QUESTION FOR DISCUSSION

In the United States we have traditionally favored competition as the way to assure that our production and marketing system is most effective in supplying the goods and services demanded by the public. Much governmental effort goes into preventing monopoly and preserving competition. Yet much governmental effort also goes into insulating portions of the economy from the full effects of competition, to protecting the consumer from certain results of competition, and to interventions in the competitive system designed to bring about greater efficiency in marketing than competition unaided might be expected to bring. Explain in general terms what considerations have led public policy to intervene or supplement competition in these three general ways. Pick one or two examples of each type of intervention and tell why you think on balance the results were helpful or harmful.

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PART VII

MARKETING COST AND EFFICIENCY

31. THE COST OF MARKETING

The social value of marketing activity has always been subject to considerable question by the general public. In contrast, the value of manufacturing and agricultural activity has been readily accepted. The giant factory containing millions of dollars' worth of machinery, equipment, and tools and employing thousands of workers is an impressive economic entity. To the ordinary person this represents a complex and expensive enterprise, and it seems almost a miracle that the finished product can be produced as cheaply as it is. The work of agricultural production is also highly regarded. Although the investment in buildings and equipment is not so impressive as in the case of manufacturing, the investment in land is great. And it is obvious to all that much hard work and a substantial amount of time is required to grow wheat or cotton and to raise livestock.

In contrast, the work of marketing does not appear to be so impressive. The average person's principal contact with marketing is through the retail store and through advertising. Neither is a particularly effective spokesman for the marketing system. Much of the expenditure for advertising appears to the average person to be wasteful. There is a tendency to forget about the advertising messages that led to satisfactory buying decisions and to remember those that were trite and in poor taste. Likewise, one tends to forget the many successful shopping trips that were made to retail stores and to remember those which resulted in frustration because of the incompetence of a salesperson or an out-of-stock situation. In any case, the average retail store is not so impressive an economic entity to the casual observer as is the modern factory.

Much of the work of marketing, moreover, is carried on behind the scenes. The average shopper in a supermarket gives little thought to the question, "How did all of these products get here?" She does not think of the numerous agencies and people that were needed to place a particular product in a par-

ticular shelf location. She is likely to be only vaguely aware, if at all, of the work of wholesalers and warehousemen. She realizes, of course, that goods must be transported but has no idea of the cost involved. In other words, she has virtually no realization of the many marketing activities that were necessary to bring the products she buys to a convenient place of purchase. She does realize, however, that these products cost more than she would like to pay, or more than they did last week, or more than they do in a nearby larger city. Thus she concludes that marketing costs too much.

As a result of this type of criticism and because of the low esteem in which marketing has been held by many laymen, marketing economists have devoted considerable attention to the question of marketing costs and efficiency. They have estimated the total cost of marketing for the entire economy and for specific products. They have compared marketing costs with the costs of extraction and manufacturing. They have studied the historical trend of marketing costs to determine whether costs have increased or decreased over time. They have attempted to compare the productivity of marketing with that of extraction and manufacturing. And they have considered at some length the problem of how to measure marketing efficiency. Before further discussion of the results of these studies, however, it is necessary that certain terms be defined and basic concepts understood.

BASIC CONCEPTS

The Concept of Marketing Cost

What the cost of marketing is depends upon how marketing is defined. Essentially a distinction must be made between marketing on the one hand and growing, extraction, processing, and manufacturing on the other. These latter activities may be designated as "production." They have to do with substance and form utilities, as distinguished from the creation of time, place, and possession utilities, which is called "marketing." [1] But, having made this basic distinction between production and marketing, it is still not necessarily easy to distinguish between the two, either conceptually or in practical analysis. For example, the harvesting of grain is normally assumed to be a production activity, and the picking of fresh fruits would appear to be an analogous operation. But various studies of the cost of marketing apples have classified the

[1] In the economic sense, marketing is considered a part of production, but it seems desirable here to continue to use "production" in the narrower sense and thus to provide a distinction between marketing activity and other types of economic activity. See the discussion in Chap. 1 including footnote 8.

expenses of picking as a marketing cost. Another example of the problem is to be found in meat packing and retailing. Many retailers of poultry and meat perform some processing operations, but it is impossible as a practical matter to separate the cost of such activities from the regular costs of retailing. Accordingly, there is a tendency to classify these processing operations as marketing expense if they are performed by retailers but as production expense if they are performed by the regular packers.

These particular problems of classification, however, are somewhat minor in importance and do not necessarily affect substantially the results of cost studies. The more important over-all problem is to define marketing costs and then to obtain the necessary cost information. Thus marketing costs include the outlays made for marketing purposes at farm and local shipping points and at the mine, forest, and factory; the outlays made for transportation and storage as products move to market; the margins obtained by the various wholesale middlemen and the marketing expenses incurred by producers who market their own products; the costs of retailing; in fact, all of the expenses involved in the performance of the marketing functions regardless of the agency which actually performs them. Obviously, such information is difficult to obtain. In practice, the cost of marketing a commodity is often measured roughly by the difference between the price received by its producers and the price paid for it by final consumers. This difference thus includes all marketing expenses, including transportation charges, of the marketing agencies. It also includes entrepreneurial profits, which are necessary to keep these agencies in the business of supplying marketing services, and which therefore are properly regarded as a marketing cost.

But this difference or spread between producer price and consumer price is not an entirely accurate measure of marketing cost, because it does not include the marketing expenses of the producer. In the case of agricultural products, the omission may not be a serious one. Since marketing costs which take place at the farm are difficult to measure with accuracy, and since they are usually small in amount, the price paid the farmer for his product at either the farm or local shipping point is usually considered as a remuneration for the cost of production, and marketing expenses are considered as beginning at this point. In some cases, it may be correct to use the same basis in measuring the cost of marketing manufactured goods, for example, when a manufacturer supplies assembly parts to another manufacturer under a long-term contract. But in most instances manufacturers exert a considerable amount of marketing effort, and it is definitely inappropriate to ignore their marketing expenses. In many cases, the marketing effort of manufacturers is substituted for that of regular wholesalers and retailers. Even when this is not the situa-

tion, the marketing costs of manufacturers may be quite large in relation to sales volume. Therefore, any reasonably accurate study of the cost of marketing should add the marketing costs of manufacturers to the difference between producer price and consumer price. Even this approach ignores some marketing costs, including those of the consumer-buyer, but it is probably as accurate an approach as can be devised considering the present status of statistical information on costs and prices.

Value Added by Distribution [2]

The advancement of the concept of value added by distribution, or marketing, during the fifties is in part at least an effort to place marketing costs in a more favorable light. The term "cost" has a negative connotation, especially in view of the fact that historically much has been said and written about *high* marketing costs. "Value added" is a more positive term; it connotes a contribution or addition to the economy rather than a subtraction, output rather than input. Actually, value added by distribution and the cost of marketing are not strictly speaking the same thing, but because of difficulties in obtaining adequate data on value added it is necessary at present to use a cost approach in its computation. Accordingly, there is a tendency to use the two terms interchangeably.

The concept of value added by distribution is adapted from the similar concept for manufacturing as used by the Bureau of the Census to measure the contribution of various types of manufacturing enterprises. Value added by manufacturing is obtained by subtracting from the total value of shipments the cost of materials, supplies, containers, fuel, purchased electric energy, and contract work. The result is the value added by a specific manufacturer through his own processing or fabricating efforts, in other words the cost, including profits, of manufacturing. Incidentally, it should be noted that value added by manufacturing under this definition also includes all value added through the marketing efforts of manufacturers.

A comparable method of computing value added by distribution would be to subtract from the net sales of a retailer or wholesaler the cost of goods

[2] Probably the most complete analysis of the concept of value added by distribution, together with its uses and limitations, is to be found in Theodore N. Beckman, "The Value Added Concept as Applied to Marketing and Its Implications," pp. 83–99; David D. Monieson, "On Measuring Value Added by Marketing," pp. 111–36; together with discussions by Carey P. Modlin, Jr., pp. 101–10, and Donald R. G. Cowan, pp. 137–42; in Stewart H. Rehwoldt (ed.), *Frontiers in Marketing Thought*, Conference of the American Marketing Association, December 1954, published by the Bureau of Business Research, Indiana University.

sold plus the cost of supplies, containers, fuel, and purchased utilities. The balance would represent the contribution of the marketing agency to the economy. At present, however, the necessary data with respect to the cost of purchased supplies, containers, fuel, and utilities are not collected by the Census for marketing agencies. Therefore, the best approximation for computing value added is to use the gross margins—net sales less cost of goods sold—of wholesalers and retailers. The result is the same as the cost of marketing insofar as these agencies are concerned and is essentially an input measure rather than one of output, as is the value added by manufacturing for that matter. Moreover, unless adjustments are made for value added by transportation agencies and for manufacturers' marketing activities, which is seldom attempted, the value added figure is considerably understated. For these reasons, we shall continue in the present discussion to talk about cost of marketing rather than value added by distribution, but this is not to be taken as an implication that the marketing system does not add value to the products it handles. It does add value but the amount does not appear to be easily determinable

The Problem of Marketing Efficiency

As more and more information has been collected about marketing costs, more and more questions have been raised regarding the significance of the data. Are costs high or low? Is marketing wasteful? What do these costs indicate regarding the efficiency of marketing? The answer, of course, is that cost alone does not give any indication of efficiency especially when there is no available standard of comparison, no basis for determining what the cost ought to be. The result is that there has been a considerable interest on the part of marketing students in the problem of efficiency and its measurement. But what is meant by efficiency?

Social efficiency is concerned with value productivity, with the determination of the value of the output of the marketing system and with the comparison of this value with some measure of total input.[a] But the output of the marketing system is represented by the amount of consumer satisfaction that is created, and no accurate method exists by which this satisfaction can be measured. It might be argued that the amount of consumer satisfaction is equivalent to the cost of marketing or to the gross margins of marketing agencies (value added), but these are really measures of input and one cannot

[a] "An Outline of Distribution Costs," report of a subcommittee of the Distribution Cost Committee of the American Marketing Association, *Journal of Marketing*, July 1951, p. 52.

obtain an index of efficiency by using an input factor as the measure of output.[4] The problem of measuring social efficiency, i.e., the productivity of the marketing system, therefore has not been solved.

Private or technical efficiency is, however, another matter. This is essentially an engineering concept, and in many instances engineering standards can be established. So long as the objective is limited to a particular operation or to a particular firm or even to a particular segment of the economy, it may be possible to measure inputs and outputs in physical or financial terms and to arrive at indexes of efficiency. For example, the efficiency of a warehouse operation might be measured in terms of the tonnage handled per man-hour of labor, or that of a transportation agency by the number of ton-miles hauled per dollar of capital investment and per dollar of wages paid. A retail store may compare its sales volume per square foot of space utilized with comparable ratios for similar stores in an effort to arrive at a judgment with respect to its efficiency. Even with such measures as these, however, it is not possible for many marketing agencies to obtain the necessary input and output information. Therefore, the measurement of marketing efficiency even at the level of the individual firm has not progressed so far as most marketing students would wish. In view of the difficulties involved in measuring efficiency, the immediate discussion will be concerned primarily with marketing costs.

THE LEVEL OF MARKETING COSTS

It has become generally accepted that the cost of marketing in the United States amounts to approximately 50 per cent of the final prices paid by consumers, the other 50 per cent being attributed of course to production. It should be emphasized that this figure applies to the distribution of tangible commodities and does not include services. The figure of 50 cents of each consumer dollar for marketing costs applies to the economy rather than to any particular product, and is based on the results of several studies of the subject.

Studies of Total Costs

Undoubtedly the most widely quoted study of marketing costs is the report of the Twentieth Century Fund, *Does Distribution Cost Too Much?*,

[4] Harold Barger in *Distribution's Place in the American Economy since 1869* (Princeton, N.J.: National Bureau of Economic Research and Princeton University Press, 1955), obtained a measurement of productivity by using value added as the output factor and man-

published in 1939.[5] This report analyzed the Census of Business data for 1929 and concluded that the cost of commodity marketing amounted to almost 59 per cent of the prices paid by consumers for finished goods.[6] This figure, although widely accepted, appears to have been too high. A correction in the method of computation, which appears to be in order, gives a figure of 51.1 per cent rather than 59.[7]

This revised figure is also closer to the results obtained by other studies. Converse, using a value added approach and allocating total value added between production and marketing, arrived at a marketing cost figure of 52.2 per cent for 1929. This was later revised downward to approximately 49 per cent. An unpublished study cited by Converse and made by Leroy H. Mantell of the United States Department of Commerce obtained figures of 50.9 for 1929 and 50 for 1939. Further studies by Converse for later years show marketing costs of 50.5 per cent for 1939 and 48.1 for 1948.[8] These percentages apply, of course, to commodity distribution.

A new study of marketing costs is currently being made by Reavis Cox for the Twentieth Century Fund. Final conclusions have not yet been published, but preliminary indications are that Cox will obtain a somewhat lower figure for the fifties than those computed for earlier years. Depending upon the definition of marketing finally adopted and upon the portions of the economy excluded and included, the figure for marketing cost may well turn out to be no greater than 40 per cent for all goods and services. Even if the analysis is restricted only to commodities that are sold to household consumers, Cox indicates that the cost of marketing does not exceed 46 or 47 per cent of final consumer prices.[9] Whether the cost of marketing is declining relative to production cost or whether the earlier estimates are too high is

hours of labor as the input factor. The results, however, are used only to show the relative changes in labor productivity for production and for marketing between 1869 and 1949. These results are presented at a later point in this chapter.

[5] Paul W. Stewart, J. Frederic Dewhurst, and Louise Field, *Does Distribution Cost Too Much?* (New York: Twentieth Century Fund, 1939).

[6] *Ibid.*, p. 117.

[7] A discussion of the error is to be found in Wilfred Malenbaum, "The Cost of Distribution," *Quarterly Journal of Economics*, February 1941, pp. 255–70. Malenbaum states that the authors of *Does Distribution Cost Too Much?* in computing the distribution cost ratio should have used as a denominator net commodity product rather than terminal buyers' outlays. Reavis Cox states that the authors accepted the correction. See his article, "What Is Happening to Marketing Costs?" in Frederick E. May (ed.), *Increasing Sales Efficiency*, Michigan Business Papers No. 35 (Ann Arbor: Bureau of Business Research, University of Michigan, 1959), p. 41.

[8] For the sources of figures quoted in this paragraph, see Paul D. Converse, "The Puzzle of Marketing Costs," *Journal of Marketing*, April 1957, p. 441; the same author's "The Total Cost of Marketing," *Journal of Marketing*, April 1946, p. 389; and Paul D. Converse, Harvey W. Huegy, and Robert V. Mitchell, *Elements of Marketing*, 6th ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1958), Appendix A, pp. 742–5.

[9] See Reavis Cox, *op.cit.*, pp. 36–49.

not evident at the present time, but there is certainly an implication in Cox' work that we should not accept too readily the general conclusion that marketing costs amount to 50 per cent or more of commodity prices.

Studies of Marketing Margins

Two other studies of marketing costs have had somewhat different objectives from the studies just cited but are important in any discussion of the subject. They have not attempted to obtain a total cost of marketing for the economy for the purpose of comparing it with production, but have been concerned with a particular segment of marketing cost or a particular segment of the economy. These studies emphasize the changes in marketing costs over periods of time and thus permit time comparisons to be made, something that has not been attempted at least in a comprehensive way by the studies previously discussed. The two studies referred to are the historical analysis of wholesale and retail margins by Harold Barger for the National Bureau of Economic Research and the continuing studies of the United States Department of Agriculture on the so-called marketing margins for agricultural products.

Wholesale and Retail Margins. The Barger study [10] is concerned primarily with changes in productivity in the economy of the United States between 1869 and 1949 and in particular with the relative rates of change to be found in commodity distribution compared with commodity production. Man-hours of labor is used as the input factor and value added as the output factor. Value added by distribution was obtained for the various years by estimating the gross margins of the several types of wholesalers and retailers.[11] An average gross margin for all wholesalers and all retailers for each year studied was then obtained by weighting the individual gross margins according to commodity output or volume of sales. Because of the lack of information prior to 1929 on the volume of sales made by the various types of distributive outlets, this basis of weighting could be used only for the years 1929, 1939, and 1948. The commodity output method of weighting was used for the earlier years. The final results are shown in Table 31-1. There are two figures for 1929, the first one being obtained by the commodity output method and the second by the volume of sales method.

[10] See footnote 4 for the complete reference.

[11] The gross margin figures are estimates based on a painstaking search of all published sources of margin information from 1865 to 1948. In many cases, especially in the earlier years, data were available for only a limited number of stores. There is no way to estimate whether the amount of error involved in the final estimates of realized margins is significant.

TABLE 31-1

Average Gross Margins of Wholesalers and Retailers, in Per Cent of Retail Value, Selected Years, 1869–1948

Year [a]	*Margins of Wholesalers*	*Margins of Retailers*	*Total*
1869	9.5	23.2	32.7
1879	9.6	24.1	33.7
1889	9.6	25.1	34.7
1899	9.2	26.2	35.4
1909	8.9	27.6	36.5
1919	8.5	28.0	36.5
1929	8.1	28.9	37.0
1929	8.0	28.6	36.6
1939	7.6	29.7	37.3
1948	7.7	29.7	37.4

[a] Data for the first seven years shown in the table are comparable with one another but weighted on a somewhat different basis than the data for the last three years. The two 1929 figures give some indication of the differences. See text discussion.

Source: Harold Barger, *Distribution's Place in the American Economy since 1869* (Princeton, N.J.: National Bureau of Economic Research and Princeton University Press, 1955), pp. 57 and 60.

The principal significance of the data in the table is that they show a generally increasing cost of distribution between 1869 and 1948. Although the gross margins of wholesalers as a percentage of retail values declined almost constantly over the period, the increases in retail margins more than offset this. It seems likely that a partial explanation lies in the greater use of direct buying by retailers and the increasing tendency for certain types of retailers to assume both wholesale and retail functions. Thus the costs of wholesalers as such declined, but the costs of retailers increased and total costs also increased.

These data should not be interpreted as proof that marketing has become less efficient over the years. The data in fact really indicate little about efficiency. Certainly the task of the marketing system changed greatly between 1869 and 1949. Not only was the product mix in the more recent years much more complex, but the amount of service and the way in which services were rendered by marketing agencies also were quite different. Changes in the number and distribution of the population, as well as in the location of production facilities, have also affected the magnitude of the marketing task. Nevertheless, Barger's study of marketing margins is of considerable interest in showing the trends that have taken place. It is confined, however, to retailers and

wholesalers and does not treat the marketing costs of manufacturers except for the cost of manufacturers' sales branches classified as wholesalers in the Census of Business.

Marketing Margins for Agricultural Products. The United States Department of Agriculture has collected information for some time on the marketing margins for agricultural products. Its primary interest is in determining what proportion of the consumer dollar spent for final products is received by the farmer. The procedure followed is to obtain the total number of dollars spent by consumers at retail and the number of dollars received by farmers. The difference between these two figures is designated as the marketing margin. Obviously this is not a marketing margin as the term is used by marketing students, since it includes all processing costs. For this reason, there has been a good deal of criticism of the definitions used by the Department on the basis that the marketing margins are overstated and the marketing system therefore appears to be more costly than it really is. Of course, it is difficult to separate marketing and processing costs for most agricultural products.[12]

The most comprehensive single statistical series published by the Department of Agriculture with respect to marketing margins is its composite series involving a designated market basket of farm foods. This series goes back to 1913 and shows the farmer's share and the marketing margins as percentages of composite retail prices for each year since that time. The data indicate that the farmer's share of the retail price for the market basket has ranged from 53 per cent in 1945 to 32 per cent in 1932 and 1933. The so-called marketing margins then have ranged from 47 to 68 per cent. The farmer's share was highest during the war and postwar years of 1917–19 and 1942-48 and lowest during the depression years 1931–34.[13] Since 1951, the farmer's share of the retail food dollar has declined steadily from 49 per cent in that year to 38 per cent in 1959, the lowest figure since 1939.

This trend has resulted in numerous public statements and newspaper headlines to the effect that marketing costs are taking an increasing share of the consumer's food dollar. Marketing people rejoin by saying that this is not true and that the figures really reflect increasing processing costs because

[12] For a discussion of the issues, see Theodore N. Beckman and Robert D. Buzzell, "What Is the Marketing Margin for Agricultural Products?" *Journal of Marketing*, October 1955, pp. 166–8; and Harry C. Trelogan and Kenneth E. Ogren, "What Is the Marketing Margin for Agricultural Products? A Rejoinder," *Journal of Marketing*, April 1956, pp. 403–6.

[13] For complete data for each year from 1913 to 1956, see *Farm-Retail Spreads for Food Products*, Misc. Pub. No. 741 (Washington, D.C.: U.S. Department of Agriculture, Agricultural Marketing Service, 1957), p. 100. More recent information can be obtained in *Developments in Marketing Spreads for Agricultural Products in 1958* (Washington, D.C.: U.S. Department of Agriculture, Agricultural Marketing Service, 1959), p. 6, and from the quarterly publication of the same agency, *The Marketing and Transportation Situation*.

of the greater degree of preparation required for modern ready-to-serve foods, a statement of equally questionable validity according to one authority.[14] Actually, the data tell us nothing about the cost of marketing, as distinguished from production cost, and especially about the efficiency of marketing. As much as anything, the data probably indicate that farm prices fluctuate more violently than do retail prices.[15]

More specific information regarding marketing costs can be obtained for some agricultural products from the individual commodity studies of the Department of Agriculture. Many such studies have been made, some in order to obtain the necessary information on marketing margins for the market basket of farm food products and some for other reasons. Often a real effort is made to separate marketing activities from processing activities and to show meaningful cost trends.

For example, the cost of marketing fresh fruits and vegetables during the fifties on the average ranged from 59 to 66 per cent of retail prices and in general increased during the latter part of the decade.[16] Since there is no processing involved, all costs are truly marketing costs. Further analysis indicates that transportation costs, a substantial part of total costs for these products, increased during the period, partly because of higher freight rates and partly because of longer hauls. An increasing proportion of fresh vegetables was being produced in areas located far from the consuming markets, thus increasing the size and scope of the marketing task. Certain other developments, such as cheaper fiberboard containers and self-service retailing, probably tended to reduce marketing costs in relation to what they would have been otherwise.

Milk is a product which has both processing and marketing costs. These costs increased from 49 per cent of the consumer's dollar in 1951 to 57 per cent in 1959.[17] In 1957 the breakdown of costs in relation to the retail price was as follows: [18]

Average retail price per quart	24.2¢	100%
Received by farmer	10.9	45
Cost of assembly	1.2	
Cost of processing	4.3	
Cost of retailing and home delivery	5.6	55
Other expenses	1.2	
Profit before income taxes	1.0	

[14] See Bainbridge Crist. "Myths About Convenience Food Costs," *Journal of Marketing*, April 1960, pp. 49–55.

[15] See Reavis Cox, *op.cit.*, p. 46.

[16] *Marketing and Transportation Situation*, January 1960, pp. 35–8.

[17] *Ibid.*, p. 29.

[18] *The Price of Milk*, Leaflet No. 409 (Washington, D.C.: U.S. Department of Agriculture, 1958).

Assembly and retailing are clearly marketing costs. If it is assumed that one half of the "other expenses" and of profit are attributable to marketing, then marketing costs amounted to 7.9 cents or 33 per cent of the retail price, and processing costs were 5.4 cents or 22 per cent. Obviously, to say that the marketing margin for milk is equal to 55 per cent of the retail price paid by the consumer is quite misleading to the average person. The rise in costs, however, during the fifties appears to have been properly attributable to marketing and in particular to a significant increase in the cost of home delivery.

A final example of the cost studies of the Department of Agriculture will be cited—the studies involving cotton textiles. Data are presented in Table 31-2 for four different years showing the percentages of the consumer dollar

TABLE 31-2

Percentage Disposition of the Consumer's Cotton Dollar, Paid for Apparel and Household Goods, Selected Years

	Year			
Operation or Service	*1939*	*1947*	*1954*	*1957*
Received by the Farmer	9.1	14.3	14.9	13.7
Ginning and Baling	0.9	0.7	1.1	1.3
Merchandising Cotton	2.1	1.4	1.9	2.1
Manufacturing, Dyeing, and Finishing Yarns and Fabrics	18.2	14.6	12.1	12.5
Manufacturing Apparel and Household Goods	28.4	29.0	29.2	29.5
Wholesaling Finished Goods	8.2	8.0	8.2	8.3
Retailing Finished Goods	33.1	32.0	32.6	32.6
Total	**100.0**	**100.0**	**100.0**	**100.0**

Source: L. D. Howell, *Changes in American Textile Industry,* Tech. Bull. No. 1210 (Washington, D.C.: U.S. Department of Agriculture, Agricultural Marketing Service, November 1959), p. 19.

paid for cotton textile products which were obtained by the various processing and marketing operations. The marketing operations clearly include ginning and baling, merchandising raw cotton, and the wholesaling and retailing of finished goods. The total of these costs approximate 44 per cent in the average year. In addition, however, some of the costs of finishers and dyers and of the manufacturers of apparel and household goods are marketing costs, including transportation costs, rather than manufacturing costs. Without doubt, the costs involved in marketing cotton and cotton textiles exceed 50 per cent

of the retail prices for the manufactured products. How much they exceed this 50 per cent figure is difficult to say; probably they would not be in excess of 55 per cent.

Difficulties in Comparing Marketing Costs

The above studies have been presented in order to show some of the difficulties involved in computing and comparing marketing costs. It is customary to express the cost of marketing as a particular percentage of the price paid by the final consumer. But the "final consumer" of raw materials and most industrial goods is the manufacturer. The difference between the price paid by the user of a product and the price paid to the producer does represent the proportion consumed by marketing costs, provided that the producer's marketing costs are included. The use of this price makes it possible to compare various percentages with the same base. Such prices, however, are not always available, and some other basis may have to be used.

This spread between producer and final purchaser is not a true marketing cost, however, unless the product reaches the final purchaser without further processing. The existence of one or more processing operations makes it very difficult to make useful comparisons between the prices received by producers and the prices paid for their products by final consumers. This is particularly true of raw materials. Livestock is slaughtered and dressed; lumber is planed, sawed, and shaped; iron ore goes through numerous manufacturing processes. These processes involve expenses which sometimes make up a considerable part of the total spread between the producer of the raw material and the ultimate consumer. Such expenses must be excluded if accurate comparisons are to be made, and this is sometimes impossible. Food purchased in a restaurant falls into a similar category, because of the large cost of processing and service involved. Even retail costs for marketing the same products are not always comparable, because of the varying degrees of service for which consumers pay in different types of stores. The various service expenses must be separated if worthwhile comparisons are to result.

It is thus evident that great care must be exercised when drawing conclusions to be sure not only that the items compared are truly comparable, but also that *operations* are comparable. For example, some wholesale hardware establishments do no industrial selling, whereas such selling makes up a large proportion of the sales of others. The fact that a service wholesaler's expenses are higher than those of a limited-service wholesaler does not prove that the former is less efficient. Since he performs more services higher expenses are to be expected. Again the fact that department store expenses are

higher than those of some competitors does not necessarily mean department stores are inefficient or that they cannot sell at competing prices or even undersell their smaller competitors. A part of the higher expense may arise from the fact that they perform both wholesale and retail operations, and partly as a result of this they are able to buy at lower prices.

Again, it is sometimes inaccurate and misleading to compare costs of marketing at different places, because transportation costs, local expenses, and marketing problems are likely to differ. Moreover, one must be careful that he does not compare the cost of marketing products of the same variety but of different quality. The size of the shipments, distance to market, and the service performed may also vary. One of the easiest errors to make, especially in the case of agricultural products, is to compare similar quantities at different places in the marketing process. Such comparisons are obviously inaccurate for products which are processed between marketing operations. The farmer is paid for more than a pound of livestock or wheat or cotton for every pound of meat or flour or bread or cloth the consumer buys, and processing expenses have been added to marketing expenses. But even the dozen eggs or box of apples the consumer buys is often not the same dozen eggs or box of apples the farmer sells. Each has probably been sorted one or more times, some items have been thrown out as unmarketable, and some have been divided or packed into lots of higher grade for sale at higher prices.

One final difficulty should be considered. It is not uncommon to assume that, because a dealer's or manufacturer's average cost of doing business is a certain percentage of net sales, this is his expense for marketing *each* product he sells. The wholesaler who handles hundreds or even thousands of items finds it practically impossible to obtain specific cost data on each. Most of his costs are joint and, even if possible, it is usually impracticable to allocate them to each item. Expense figures under such conditions are usually averages, and may be of no real value to the dealer in determining the profitableness of selling individual products. Furthermore, the same items are sold in large and small quantities, under different conditions, and with different types of service, which add to the difficulty of comparison.

THE ELEMENTS IN MARKETING COSTS

The previous discussion has indicated that marketing costs are substantial. It will assist us in understanding why these costs are so high if we analyze more specifically where these costs take place and who incurs them. The analysis will be indicative rather than exhaustive, since the data are scattered and not necessarily up to date. The principal elements in marketing cost to

be discussed are manufacturers' marketing costs, transportation, the cost of wholesaling, and the cost of retailing.

Manufacturers' Marketing Costs

Manufacturers' marketing costs have not been studied to the extent that other costs have been because the information is more difficult to obtain. The Twentieth Century Fund study, *Does Distribution Cost Too Much?*, indicated that such costs amounted to approximately 14 per cent of the final consumer dollar spent for goods. If we accept 51 per cent as the total cost of marketing rather than the originally published 59 per cent, the figure for manufacturers' marketing costs would be 12 per cent rather than 14. Various studies by the Federal Trade Commission have indicated that the manufacturers' costs of selling, advertising, and delivery range from less than 2 per cent of manufacturers' sales for some industry groups to more than 30 per cent for others.[19] These are percentages, of course, of a smaller base than the 12 per cent figure, since the prices for commodities at the level of manufacturer distribution are considerably less than the final retail prices paid by the consumer.

In general, the marketing costs incurred by the manufacturers of consumer goods are greater than the corresponding costs incurred by the manufacturers of industrial goods. Industrial goods, as has been previously stated, are sold in larger quantities to fewer buyers than are consumer goods. They are often standardized as to quality and the buyers are well informed with respect to the characteristics of the various products. Thus the costs of performing the selling function are less for industrial goods.

Manufacturers' marketing costs, however, are still quite variable. Many industrial goods manufacturers incur selling costs of less than 5 per cent of sales, but many others have costs of from 10 to 15 per cent; and in 1940 the costs of selling, advertising, and delivery for manufacturers of office machines amounted to almost 30 per cent of sales. In the consumer goods field, manufacturers of cosmetics, drugs, bakery products, and sewing machines have relatively high selling costs, from 25 to 35 per cent or more in 1940. Automobile manufacturers on the other hand had costs of only 5.23 per cent of sales in this same year.[20] It is thus difficult to draw definite and specific conclusions regarding the level of manufacturers' marketing costs, but it is evident that they are an important element in the total marketing bill.

[19] See, for example, *Report of the Federal Trade Commission on Distribution Methods and Costs*, Part V, *Advertising as a Factor in Distribution* (Washington, D.C.: U.S. Government Printing Office, 1944), pp. 6–7.

[20] Data in this paragraph are from the source cited in footnote 19.

Transportation

The Twentieth Century Fund study indicated that transportation costs amounted in 1929 to 13 per cent of the consumer dollar spent for finished goods,[21] a little less than 12 per cent on the adjusted basis. Barger computed the cost of transportation between the producer and initial distributor only, at 4.7 per cent of retail value for the same year.[22] Subsequent transportation charges incurred are included in Barger's study in the wholesale and retail margins.

The cost of transportation varies greatly according to the particular product and depends upon such factors as bulk in relation to value, distance, special facilities needed to preserve the product en route, need for speed, necessary terminal facilities, and the type of transport used. These factors were discussed in Chapter 20. Transportation cost is a very important element in the total cost of marketing most agricultural products and raw materials. The majority of such products are bulky and many are hauled for long distances. For manufactured products, transportation cost is usually of less significance but there is considerable variation. Products with a high value and low bulk, such as textiles and tobacco products, expend less than 5 per cent of the retail value—often much less—for transportation service. Transportation of the more bulky items, however, such as brick and tile, may require an expenditure comparable to that found for agricultural products—in excess of 25 per cent.

The Cost of Wholesaling

It is not possible to obtain the cost of wholesaling as such because both manufacturers and retailers often perform wholesaling functions. Thus the cost of wholesaling is often included in some other category of marketing cost. It is possible, of course, to obtain the costs or margins of wholesalers, and from such information it may be concluded that wholesaling is the least expensive element of the marketing operation. Barger estimated total wholesale margins at approximately 8 per cent of the retail value of commodities for various years from 1929 to 1948. The Twentieth Century Fund figure for 1929 was slightly higher.[23]

[21] Stewart, Dewhurst, and Field, *op.cit.*, p. 211.

[22] Harold Barger, *op.cit.*, p. 57.

[23] The Barger figures are 7.6 for 1939, 7.7 for 1948, and 8.0 for 1929. See p. 60. The Twentieth Century Fund figure on the revised basis appears to be about 9 per cent of retail prices.

The various Censuses of Business give information on the operating expenses of the several types of wholesalers classified by product groups. These, of course, are expressed as a percentage of wholesale sales not as a percentage of retail value. Moreover, these expense ratios do not show the total cost of wholesaling any given group of products because some products are handled by more than one wholesale middleman. In general, however, these expense figures indicate that the cost of wholesaling is greater for such product groups as furniture, automotive equipment, hardware, construction materials other than lumber, and commercial machinery and equipment than it is for staple items such as groceries and tobacco. Products such as drugs and wearing apparel are in an intermediate position with respect to cost. Many of the products with relatively high wholesaler costs are products which are most likely to be sold directly by the manufacturer to the user rather than through wholesalers. Wholesalers then handle small orders and emergency orders which are costly, and this accounts at least in part for the high expense ratios.

Wholesaling is often criticized by the uninformed as being an unnecessary operation in the marketing system. The necessity of performing the wholesaling functions has been established, however, in previous chapters. It is now evident that the performance of these functions by wholesalers is the least expensive element in the total cost of marketing.

The Cost of Retailing

Retailing is the most expensive step involved in marketing goods for personal consumption. Barger's estimates of average retailer margins for 1929, 1939, and 1948 ranged from 28.6 to 29.7 per cent of retail value.[24] The common cost of retailing even staple commodities ranges from 15 to 30 per cent of the price paid by the consumer, and for many items the retail margin is even higher. Examples of some typical gross margins and expense ratios are given in Table 31-3. Figures of this kind prove nothing in themselves regarding the effectiveness of retailing. They do show, however, that we pay heavily for the retailer's service, and they also indicate that net profits are not excessive. Furthermore, the range in expenses of retailers of substantially the same character is so great[25] that it seems entirely possible that many retail stores are operated at an excessive cost.

No definitive judgment can be made, however, on these matters. Retailing even at its most efficient level is an expensive operation. Individual contact is made with each buyer. Transactions involve relatively small quantities

[24] Barger, *op.cit.*, p. 60.
[25] The ratios in Table 31-3 are averages of approximately 200 stores in most instances.

TABLE 31-3

Gross Margins, Expenses, and Net Profits of Selected Types of Retailers for Specified Years (as per cent of net sales)

Type of Retailer and Year Survey Made	*Gross Margin*	*Total Expense*	*Net Profit Before Income Taxes*
1957			
Children's and Infants' Wear Stores	32.5	30.8	1.7
Dry Goods and General Merchandise Stores	29.5	27.6	1.9
Gift, Novelty, and Souvenir Stores	40.0	38.1	1.9
1956			
Family Clothing Stores	30.6	27.9	2.7
Farm Supply Stores	15.9	14.4	1.5
Gasoline Service Stations	23.2	22.1	1.1
Music Stores	35.8	33.3	2.5
Paint and Wallpaper Stores	33.1	30.1	3.0
1955			
Auto Accessory and Parts Stores	34.4	31.7	2.7
Candy, Nut, and Confectionery Stores	35.8	35.4	0.4
Lumber Dealers	24.5	21.1	3.4
Package Liquor Stores	19.7	17.1	2.6

Source: Elmer T. Sivertsen, various surveys on *Cost of Doing Business,* Dun & Bradstreet, Inc., various dates.

in comparison with industrial goods. And the ultimate consumer is a difficult taskmaster to serve. Many of the costs of retailing exist because consumers insist on certain services. These and other reasons for the apparently high over-all cost of marketing will be discussed in the following section.

REASONS FOR HIGH MARKETING COSTS

The level of marketing costs is determined essentially by the nature and complexity of the marketing task to be performed and by the efficiency with which it is performed by marketing agencies. As has been previously stated, measures of social efficiency are difficult, if not impossible, to obtain. But there can be little doubt that there is inefficiency in the marketing system, just as there is inefficiency in production. This matter of efficiency and its effect on costs will be discussed in the following chapter. The balance of the present chapter will be concerned with a discussion of the marketing task itself. Regardless of the technical efficiency with which marketing is per-

formed, the work of marketing is so important and so complex that its cost in a modern economic society must constitute a significant proportion of the value of the final product.

The Increasing Importance of the Marketing Task

In a self-contained economy with handicraft methods of production, little marketing effort is required. Many of the necessities of life are produced directly by those who consume them, and there is little exchange of commodities among individuals. When exchange does take place, goods are produced to order by a craftsman and delivered directly to the buyer who pays in cash or in bartered commodities. There is very little marketing cost involved, but by the same token the prices of goods to the consumer are high and the level of living is low. Our modern economic system then is not to be judged on the basis of how high marketing costs are but on the basis of the net cost of production and marketing combined. For, as production becomes larger in scale and more specialized, as products are manufactured to stock and not to order, and as consumers demand a greater and greater variety of goods, marketing becomes more and more important and more and more costly. But the net result is lower prices to consumers and a higher level of living.

Effect of Specialized and Large-Scale Production on Marketing. Our present complex marketing system is in part, therefore, a result of the development of specialized and large-scale production. Wheat and corn could be grown in almost any part of the United States and each locality could rely upon its own production, thus holding marketing costs to a minimum. But many areas would have a very low per capita production and the cost of that production would be high. It is actually much more economical to grow wheat in Kansas and corn in Iowa on a large scale and to incur the marketing expenses, including the cost of a long transportation haul, necessary to deliver the products to consumers in those parts of the country which cannot produce them advantageously.

Likewise, it would be possible to locate many small manufacturing plants throughout the United States with each plant producing only the limited quantity required for local needs. But such production would in most cases involve a very high-cost operation, not only because of locational disadvantages with respect to raw materials, power, and similar factors but also because a plant of such small size would be unable to realize economies of scale. Accordingly, it is again more economical to concentrate manufacturing in those areas best adapted for it and to incur higher costs of marketing. Thus the

result in our modern economy is that marketing costs constitute a significant proportion of the prices paid by final consumers, but the combined cost of production and marketing is lowered by the specialization that takes place in production.

Effect of Producing in Anticipation of Demand. As production becomes larger in scale and more specialized, goods are produced for the market in anticipation of demand rather than upon the direct order of the customer. This affects the marketing task and the cost of performing it in a number of ways.

In the first place, goods produced for the market must be held until consumers demand them. They must be stored and warehoused and they must be financed during this interim period of time. As previously noted, many products are subject either to seasonal production or to a seasonal pattern of consumption. Both conditions place an additional burden upon the marketing system and tend to increase the costs of storage and financing. But regardless of the problems of seasonal adjustment, the marketing costs involved in the creation of time utility have been greatly affected—in fact they have been virtually created—by the development of modern production methods.

Secondly, production for the market involves substantial risk which also adds to marketing costs. Products which are perishable must have special care in order to avoid physical deterioration and even then some losses are likely to take place. Of even greater importance is the need to forecast and anticipate consumer tastes. The risks associated with fashion merchandise are illustrative and generally understood. But fashion change represents only one aspect of the problem. New and improved products are constantly being placed on the market. Some are successful in attracting consumer patronage and some are not, but the costs of innovation in either case may be substantial. Likewise, existing producers are faced constantly with the threat of product obsolescence as improved articles are placed on the market. Thus an important part of the marketing task in a modern economy is to forecast consumer demand and changes in consumer tastes. This adds considerably to marketing costs but failure to forecast accurately results in even greater losses.

Finally, since production for the market does involve the risks associated with consumer demand, considerable effort is made to influence this demand. This effort involves the entire selling function: product planning and development, branding, packaging, and the use of salesmen, advertising, and various sales promotional methods. Many services are also rendered in connection with the sale of the product. Such efforts often tend to add substantially to the cost of marketing. They may or may not add to the total costs of produc-

tion and marketing combined. In some cases, additional volume of sales obtained through these demand-influencing efforts is sufficient that production costs and other marketing costs are reduced as a result of the greater volume manufactured and handled. But many of these selling expenses are incurred as a result of the keen competition to maintain the existing level of sales, and it is not necessarily true that other costs are thereby reduced.[26]

The Importance of Labor in Marketing

A second reason for the existence of high marketing costs is the fact that marketing requires a large amount of human labor to perform its work. The greatest single element in marketing cost is the expenditure for wages and salaries. Labor-saving equipment and machinery have not been adapted to marketing so successfully as they have to manufacturing. Thus a constantly greater proportion of the labor force of the United States has been employed in marketing activities.

Between 1870 and 1950, according to the study by Barger, the number of persons engaged in distribution, i.e., retail and wholesale trade, increased from 6.1 per cent of the total labor force to 16.4 per cent.[27] For every thousand persons engaged in commodity production in 1870, there were fewer than 100 engaged in commodity distribution. By 1950, there were about 400 in distribution per thousand in production. During this 80-year period, the numbers engaged in distribution per thousand engaged in production increased at an average annual rate of 2.1 per cent.

The reasons for this greater relative growth of employment in distribution lie to some extent in the increasing magnitude of the marketing task but even more in the way in which this task is performed.[28] One factor certainly is the increasing proportion of commodities entering the distribution system. As pointed out previously, when production is carried out on a small scale and with little specialization, a minimum of marketing effort is likely to be required. As production becomes larger in scale and more specialized, the task of marketing becomes more complex. One evidence of this fact, and

[26] Further discussion of the efficiency of competitive selling will be found in the following chapter.

[27] Harold Barger, *Distribution's Place in the American Economy since 1869*, *op.cit.*, Chap. 1, esp. pp. 6–10. These figures do not include persons employed by manufacturers for marketing purposes or those employed in transportation.

[28] There is one exception to this statement. Barger points out that the average hours worked per week per person in distribution declined between 1870 and 1950 much more than did the average hours worked in commodity production. The importance of this factor in the growth of employment in distribution is difficult to assess, since it involves some evaluation of the efficiency of persons working long hours as well as other factors. Barger states that it represents only a small part of the explanation, *op.cit.*, p. 19.

probably the only one that can be measured even approximately, is the increasing proportion of commodity output handled by the distributive system. Barger's analysis does indicate that the quantity of finished goods sold through retail stores increased more rapidly, especially between 1869 and 1909, than did total commodity output.[29]

A second factor contributing to the greater magnitude of the marketing task since 1869 is the increase in the marketing functions performed. Despite the fact that some developments, such as self-service retailing and cash-and-carry methods, have resulted in the performance of fewer functions, it seems likely that the services of marketing have expanded. Barger specifically mentions such things as improvements in retail store facilities and more liberal return and adjustment privileges. It is not possible, however, to measure these services and functions in quantitative terms and to balance expansions in services against curtailments. Barger's conclusion is that the net change has been in the direction of greater service but that the change is not large. It seems likely, however, that the segments of the marketing economy not studied by Barger—transportation, warehousing, and the marketing activities of manufacturers—have definitely improved and extended the marketing services rendered during this period.[30]

The final and most important factor leading to greater employment in marketing, according to Barger, is the fact that the amount of goods distributed by retailers and wholesalers per man-hour of employment rose less rapidly between 1870 and 1950 than did the output per man-hour in commodity production.[31] Labor productivity rose only 1.0 per cent per year in distribution compared with 2.6 per cent in production. This fact reflects primarily the way in which the marketing task is performed. Marketing emphasizes personal service rather than mechanized operations. The rate of technological advance, accordingly, has been far less rapid in marketing than it has been in production. In addition, the amount of capital per worker has increased more rapidly in manufacturing than it has in retail and wholesale trade.

Marketing, of course, can point to some technological advances: improved equipment for handling goods in warehouses, automatic controls at the check-out counters of supermarkets, the automatic order-handling equipment used by some wholesalers, the computers used in inventory control, automatic vending machines, and many others. But obviously, these advances are minor compared with the degree of automation achieved in modern manu-

[29] *Ibid.*, p. 27.

[30] It is not the purpose here to attempt an extensive analysis, but the discussion in previous chapters of this book is indicative, for example, Chaps. 15, 20, and 21.

[31] *Ibid.*, p. 10 and Chap. 3.

facturing operations. There are visions, even forecasts, of a more completely automated marketing system. Much of this will be achieved at the intermediary levels of distribution, but it remains to be seen whether significant accomplishments can be made at the retail level. Marketing deals with the ultimate consumer, a person with a buying problem. Thus far, marketing has seen fit to rely extensively on person-to-person contact to perform its work, and this necessarily results in high costs. Even if the technological difficulties are overcome with respect to automation in marketing, there may well be a question of what the consumer will accept. In the meantime, it is important to understand that one of the reasons for high marketing costs is the fact that the marketing system relies largely on labor to perform the work of marketing.

The Role of the Consumer

The services rendered to consumers by the marketing system constitute a third reason for high marketing costs. Such services as free delivery, credit extension, and the returned goods privilege add to the costs of retailing. The fact that many retail stores remain open at night as a convenience to shoppers is another service that adds to costs. But many of the services received, and presumably demanded, by consumers are less obvious. Products must be available, apparently, in a multiplicity of brands and in several different package sizes of each brand to accommodate various consumer needs. Automobiles and other products come in a variety of color combinations to provide more freedom of consumer choice. The result for wholesalers and retailers is larger inventories, a lower rate of stock turnover, a greater investment in merchandise, and higher expenses. And each retailer is expected to have each of these items in stock at the exact time that the consumer requires it.

Without doubt, commodities as such could be distributed at a lower cost if some of the attendant services were discontinued or reduced in quantity or frequency. And there have been several developments in this direction. During the past 30 years, grocery stores generally have adopted self-service and cash-and-carry methods that have apparently resulted in lower prices to consumers. During and since World War II, the daily home delivery of milk has been largely replaced by alternate-day delivery, at a cost saving once estimated at more than a cent per quart.[32] In recent years, most department

[32] The saving during World War II amounted to 1.1 to 1.4 cents per quart according to R. G. Bressler, Jr., and Alan MacLeod, "Connecticut Studies Milk Delivery," *Journal of Marketing*, October 1947, p. 215.

stores have reduced the frequency of delivery service and have restricted the area in which free delivery is made.[33] Other examples could be given. But the question involved is what effect such curtailments have had on consumer satisfaction. It is true that marketing costs have been reduced so far as the marketing agencies are concerned. It is probably true that the consumer has obtained lower prices than would otherwise have been available. But it is also true that the consumer's own marketing costs have increased in some cases and that the consumer has incurred added inconvenience in others.

It is not easy to determine what the consumer wants in the way of service. The modern housewife shopping in a supermarket undoubtedly takes more time and probably incurs more personal expense than did her mother or grandmother who ordered groceries by telephone or walked a block to the neighborhood store. In this case, however, the consumer has made a clear-cut choice. She prefers, at least for the time being, the lower prices and the cash-and-carry service—and perhaps the shopping atmosphere—of the supermarket. The development of the discount house also points, but not so clearly and specifically as yet, in the same direction. On the other hand, a very large number of retailers are still obtaining patronage on the basis of customer service and convenience. Moreover, even the supermarket has been forced to offer services of certain types in order to retain patronage: night openings, prompt check-out service, an attractive store, modern display equipment, and a large and varied selection of merchandise. It is entirely possible that these services add as much to marketing costs as did the credit and delivery service offered by the old-time grocer.

Consumer service and convenience thus take many forms and add to marketing costs in varied ways. Consumer satisfaction is the final test of whether these costs are justified, and no valid method has been determined of measuring this satisfaction. Consumers do, of course, make choices in the market place, and by their actions they influence the types of service rendered by marketing agencies. When certain services are curtailed or abandoned without a significant reduction of consumer patronage, it may be assumed that there is little loss of consumer satisfaction. But curtailment of services does not necessarily mean that real marketing costs have been reduced. In some cases, such as delivery, the consumer merely takes over the performance of the function, receiving perhaps a price discount from the marketing agency for so doing. And the net result may well be an increase in consumer satisfaction.

[33] At one time, many department stores in the United States would prepay parcel post or freight charges on merchandise purchased from the store by out-of-town cutomers. This service was extended to shipments within a rather wide trading area, or occasionally to any place in the United States. Substantial curtailments have been made in this service.

There is really no question of marketing efficiency involved here. The rendering of consumer services which result in high costs—and great satisfaction—does not indicate inefficiency in the marketing system. By the same token, low marketing costs brought about by an absence of service does not indicate that a high degree of efficiency exists. In fact, undeveloped marketing systems are likely to be both low in cost and low in efficiency. There is, of course, a question of the efficiency with which the marketing system and individual marketing enterprises perform these services and the other marketing functions. This question will be discussed in the following chapter.

QUESTIONS FOR DISCUSSION

1. From time to time, it has been suggested that a differentiated pricing system should be established at retail, i.e., that each retail store should have separate prices for each article according to the amount of service used by the consumer. It is argued that such a pricing system would give the consumer a choice between higher prices with service and lower prices with a minimum of service. During World War II, a group of I.G.A. service grocery stores established cash-and-carry prices considerably lower than the previously existing service prices. At the same time, they instituted a service charge for credit extension of 2 per cent of the monthly bill and a delivery charge of 15 cents per delivery. After one year, most stores reported that the character of their business had changed from 80 per cent credit and delivery to 80 per cent cash and carry.

   What, if anything, does this tell us about the probable success of a differentiated pricing system and about the consumer demand for service?
2. A manufacturer of wickets incurs marketing costs equal to 15 per cent of his sales volume. The wholesaler's gross margin is 20 per cent of his selling price and the retailer's gross margin is 37.5 per cent of the final retail price. Assume that the cost of transportation is included in these percentages. Compute the total cost of marketing as a per cent of the retail price of the wicket.
3. Why does marketing cost as much as it does?

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See also references at the end of the following chapter.

32. MARKETING EFFICIENCY

The cost studies cited in the preceding chapter indicate that it costs about as much to market consumer goods as it does to produce them. There is also evidence that marketing costs have been increasing, at least in relation to production costs. The conclusion often drawn from these facts is that marketing costs too much and the marketing system is inefficient. A number of reasons have been presented, however, to explain why marketing costs are substantial, and the data on marketing costs really tell nothing about the effectiveness with which the marketing service is performed. Since it is very difficult to measure the efficiency of marketing, it is not easy to draw definitive conclusions on this subject. It is possible, nevertheless, to examine some of the criticisms that are made of the marketing system that relate to efficiency. In addition, it is possible to discuss some of the sources of inefficiency of the individual business enterprise and to point out improvements that are being made, and that might be made, to reduce costs and improve efficiency.

It is thus evident that two points of view must be kept in mind in any attempt to analyze marketing efficiency. The first is the point of view of the private businessman who is concerned with his own particular business problem. His aim is to obtain a competitive advantage through superior operating efficiency, lower costs, and better service. The second is the social or public point of view. Here the aim is to determine whether the marketing system as a whole operates effectively in its effort to serve consumers. From this point of view, marketing appears as an intricate mechanism for bringing goods and services from producer to consumer. The mechanism functions imperfectly at times and involves expensive processes. It is, consequently, worth a great deal of study in order to determine whether it can be made to function more effectively and more economically.

The immediate aims of those persons who analyze marketing from the social point of view frequently, perhaps usually, coincide with those of men

and organizations that are interested from the point of view of private enterprise. Both desire to reduce costs and improve efficiency. If private businessmen achieve these objectives on a wide scale, the result will surely be to improve the entire marketing system. But the private businessman is basically interested in his own profit situation more than he is in the total marketing organization of the economy. Therefore, it is desirable to look at the criticisms of marketing from the social point of view before discussing the problem of technical business efficiency.

SOCIAL EFFICIENCY OF MARKETING

As was indicated in the previous chapter, the measurement of the social efficiency of marketing requires the establishment of input-output relationships. And both input and output are very difficult to determine. The output of the marketing system is the amount of consumer satisfaction created, an intangible and philosophical something for which as yet no procedure for measurement has been established. The input of the marketing system consists of the individual effort necessary to produce the output of consumer satisfaction. This effort is also difficult to measure although labor hours, labor cost, and the cost of capital are sometimes used as measures of input. But input factors are often jointly incurred by both marketing and production, as in the case of the efforts of manufacturers, and the portion attributable to each may be very difficult, if not impossible, to determine.

Therefore, it is not the purpose of the present discussion to attempt to measure the social efficiency of marketing. Rather the discussion is concerned merely with certain common criticisms of marketing from the point of view of social performance. To the extent that these criticisms are valid, they indicate something about marketing efficiency. They do not tell us how inefficient marketing is nor even necessarily whether significant improvements can be made. Certainly, they give us no valid comparison between production efficiency on the one hand and marketing efficiency on the other. But, to some extent at least, they do provide a framework of reference for further study and for a general evaluation of the marketing system.

Too Many Middlemen

Many people believe that the vertical subdivision of the marketing process among middlemen has gone too far; that is, that there are too many successive, independently operated steps for the most economical marketing. Others believe that there are too many retailers and wholesalers of each class

for economical marketing—too many drug stores, too many appliance dealers, or too many machinery wholesalers. The criticism that marketing costs are increased by virtue of too many middlemen must be examined then from two points of view, the number involved vertically in the channel of distribution and the number involved horizontally at any given stage of the distribution process.

Number of Middlemen in the Channel of Distribution. Much of the argument for eliminating the middlemen who operate in the channels of distribution between the producers and final users of products arises from the false notion that the fewer the distinct agencies that handle a product, the more quickly, efficiently, and cheaply it can be delivered to the consumer. In production, it is not disputed that the division of labor leads to better and cheaper output. But many fail to realize that the advantages of division of labor apply to marketing as well.

The subdivision of the marketing process between successive middlemen is basically an example of specialization and the division of labor. As such, it is commonly believed by students of marketing to result in more economical operation. There seems to be ample justification for most of the existing division of the marketing processes among specialized classes of middlemen. There is also reason to believe that lower cost and greater efficiency might be gained in some cases by further specialization. On the other hand, generalization must not be carried too far, for there have been many instances in which a merging of the operations performed by two or more classes of middlemen into the hands of one, or the combination of a middleman's operations with the marketing operations of a producer, has resulted in a reduction of costs.[1]

The point is that the marketing operations must be performed. The problem to be solved in every instance is to find the combination of operations that is most economical for performing the desired services. Middlemen seldom survive for long unless their existence is economically justified. Even when it can be shown that certain products with high marketing costs utilize a greater number of middlemen than do other products with lower marketing costs, the case against middlemen is not proved. The decision must rest on the reasons for the use of several middlemen. For some agricultural products,

[1] It is not the intent of the discussion here to give the impression that there are no instances in which a reduction in the cost of marketing can be made by a consolidation of existing middlemen. Additional middlemen rarely appear without some economic justification, but subsequent changes or developments may result in a situation in which the functions of certain middlemen can be advantageously taken over by others. This has obviously taken place during the past thirty years in the marketing of some agricultural products, as pointed out in Chap. 4, although the effect on marketing costs of this elimination of middlemen is not clear.

marketing costs are high and the number of middlemen is large, especially in relation to most manufactured goods. But the use of these middlemen appears to be the most economical method of marketing under existing conditions.

If the number of successive middlemen is an important cause for high costs, we should expect to find the cost of marketing commodities varying with the number of middlemen found between producer and consumer. But there is little evidence that this is the case with comparable commodities. The cost of selling brushes, cooking utensils, and hosiery directly to consumers, for example, is certainly as high and probably much higher than the cost of selling them through wholesaler and retailer. Characteristics of the commodities marketed, the conditions under which they are marketed, and other factors previously discussed are far more important in determining costs than is the number of middlemen in the channel of distribution.

Number of Middlemen Competing Horizontally. Many students of marketing believe that there are too many competing middlemen at each step in the marketing process. They contend that a smaller number, each doing a larger business, would operate at a lower unit cost and so reduce the cost of marketing and increase efficiency. This reasoning is based on the assumption that large-scale operations are more economical, as they are commonly assumed to be in manufacturing. Economies of scale, however, are not obtained uniformly in all industries, even in manufacturing. And there are also limits to size beyond which an increasing scale of operations may result in diseconomies. Moreover, since marketing is not highly mechanized, there is some question of whether economies of scale are as realizable in marketing as they are in manufacturing.

There appears to be a tendency, however, for costs of operation to decline in some fields of marketing as establishments grow larger. Economics of scale seem to be particularly in evidence with respect to wholesale operations. Census data for 1954 show that the operating expenses of merchant wholesalers as a percentage of total sales declined regularly and consistently with each larger sales-size group.[2] Expense ratios ranged from 31 per cent for wholesalers doing less than $50,000 annually to 5.7 per cent for those with a volume in excess of $10,000,000. A similar relationship is shown by the census data for previous years.[3]

[2] See Table 13-5 on p. 272.

[3] The regularity of the relationship pointed out here is undoubtedly affected by the fact that many of the wholesalers with low volumes handle product lines which would have high costs of wholesaling in any event. Analyses of expense ratios by product groups tend, however, to show a similar, although not so consistent, relationship between volume and operating expenses. For expense ratios of merchant wholesalers by size groups and product lines, see *U.S. Census of Business: 1954*, Vol. III, *Wholesale Trade* (Washington,

This tendency for expenses to decrease as sales increase is probably less prevalent in retailing than in wholesaling, although there is actually very little information of a comprehensive nature. A number of studies of retail expenses have shown expenses declining as volume increases up to a certain point, varying with particular lines and studies, and then beginning to increase as volume increases. Other studies have shown no general tendency at all.

Retailing has so many relatively small owner-operated establishments that the cost of doing business is more likely to depend upon the management ability of the particular owner, which varies widely, than upon the scale of operations as such. Moreover, as retailers become larger, there seems to be a tendency for them to widen product lines and to offer more elaborate service, changes which are likely to increase expense ratios. Since retail stores do offer a wide variety of products and services, it is especially difficult to determine the comparability of establishments when cost studies are made. Accordingly, we must conclude that there is little specific evidence to the effect that the costs of retailing vary significantly with changes in volume.

On the other hand, retailing institutions have operated historically on such a small scale that there has been rather general agreement that there are more retailers than there should be if the greatest economy in marketing is to be realized. In 1939 more than half of all retail stores had a sales volume of less than $10,000 per year. Considerable improvement has taken place since that time, although much of it has been due to price increases. Nevertheless, real sales volume has increased somewhat without a corresponding increase in number of establishments. In 1958 only 13 per cent of retail stores realized sales of less than $10,000, although an additional 27 per cent had an annual volume of less than $30,000.[4] Exactly what these figures mean in terms of marketing efficiency is difficult to determine. Margaret Hall and John Knapp have concluded that retailing in the United States is more productive than retailing in Great Britain because of the larger size of outlets in the United States. Moreover, they found the difference in productivity to be relatively higher where the difference in size of outlet was greater. Economies of scale were regarded as one cause of this greater productivity.[5]

D.C.: U.S. Department of Commerce, Bureau of the Census, 1957), pp. 2–2 to 2–15. Ratios for some of these product groups have also been compiled in Theodore N. Beckman, Nathanael H. Engle, and Robert D. Buzzell *Wholesaling*, 3rd ed. (New York: Ronald, 1959), p. 629.

[4] See Table 9-4 on p. 182. The 13 per cent figure for 1958 would probably have been 18 or 19 had the same methods of enumeration been used in 1958 as were used in 1939.

[5] Margaret Hall and John Knapp, "Number of Shops and Productivity in Retail Distribution in Great Britain, the United States and Canada," *The Economic Journal*, March 1955, pp. 72–88; partially reprinted in Stanley C. Hollander (ed.), *Explorations in Retailing*

Although there are undoubtedly a certain number of small stores in the United States which are not essential elements in our marketing system, it would be impossible on the basis of present information to draw any conclusion as to the approximate number. Since we have already made considerable progress toward large-scale retailing, relative to other countries and to our own previous situation, it is possible that the efficiency of marketing is not greatly affected by their presence. Moreover, the matter of consumer convenience must be considered. The fact that these very small stores do continue to exist, even though in declining numbers, is an indication that some consumers have need for their services or at least find it convenient to use them. It is hardly possible to determine scientifically and objectively the optimum number of wholesalers and retailers required in our economy.[6] It is likely that we do have too many competing middlemen, but in the United States at least it appears that the situation is not a serious one and that it is in the process of being corrected.

Cost and Efficiency in Competition

Much of the criticism of modern marketing is really pointed directly or indirectly at our competitive system as it now functions. This system encourages the establishment of all types of enterprise with the assumption that in the long run the more efficient types will survive. To a considerable extent this process of selection does take place, but there is undoubtedly some waste and inefficiency involved in the competitive system. Excesses do take place. The principal question is whether the benefits of the system outweigh the costs.

In marketing, the excesses of competition are to be found primarily in the performance of the selling function; at least this is the area which is customarily criticized. Undoubtedly, there is much duplication of sales effort in the modern economy. A multitude of brands of most products are made available to consumers through a variety of outlets, and the promotional methods used to convince consumers of the superiority of each brand or of a particular outlet are many and varied. The two fundamental methods of

(East Lansing: Bureau of Business and Economic Research, Michigan State University, 1959), pp. 85–96.

[6] See Richard D. Lundy, "How Many Service Stations Are 'Too Many'?" in Reavis Cox and Wroe Alderson (eds.), *Theory in Marketing* (Homewood, Ill.: Irwin, 1950), pp. 321–33. Mr. Lundy concluded, using various assumptions regarding maximum utilization, other products handled, and consumer convenience, that the number of service stations "needed" in 1946 for the sale of gasoline could have varied from a minimum of about 2,000 to a maximum of perhaps 5,000,000. The actual number in existence was approximately 393,000, including 180,000 retailers of other types who also sold gasoline.

selling are personal salesmanship and advertising. Of these, advertising is commonly singled out for adverse criticism on the ground that it is a wasteful and extravagant means of competition. This is unfortunate, for much of this criticism could be directed with equal or greater logic at personal selling, at the use of free samples, at the giving of trading stamps, or at the offering of expensive and duplicative services such as credit extension and delivery.

Let us take the home delivery of milk as a simple illustrative case. A certain block of a certain street contains 25 homes each of which purchases two quarts of milk daily. Five dairies deliver milk on this street and it may be assumed that each serves five of the homes, a total of 10 quarts delivered daily by each dairy. The cost of delivering milk in this block, including all truck costs and wages of the deliveryman, is 50 cents per trip—or 5 cents per quart. Alternate-day delivery, with each home receiving four quarts of milk per trip, would reduce delivery costs. The trip cost might well increase to, say, 60 cents, but 20 quarts of milk would be delivered at a cost of 3 cents per quart. Further economies could be obtained by reducing the number of dairies delivering milk in this block from five to three or even one. Thus it may logically be concluded that competition in the provision of delivery service for milk adds to marketing costs.

It is not necessarily true, however, that the interests of the consumer are poorly served by this arrangement. Complete elimination of home delivery service would require that consumers obtain their milk supplies from retail stores, perhaps at considerable inconvenience and even expense. Change from daily to alternate-day delivery is probably desirable, although some customers may have to purchase a larger refrigerator or supplement deliveries with store purchases. Reduction in the number of competing firms may provide economies, and possibly even lower prices, but this obviously can be carried too far. As the number of competing firms is reduced, the consumer has less and less freedom of choice. He may be forced to accept poorer service and a product which he regards as inferior in quality. Moreover, as the number of firms decreases, it becomes more likely that oligopolistic or monopolistic prices may prevail.[7]

This, of course, is only one example of the costs and benefits of competition. Selling efforts, in general, including advertising, may become highly competitive in nature, with costs that are excessive and wasteful. This is especially true when the selling and advertising methods are not effective in obtaining sales volume, or when the efforts of sellers counterbalance one an-

[7] In the case of milk, this possibility may not be of too great importance since a considerable proportion of the milk supply is sold under marketing agreements approved by governmental agencies. For products which are sold to a greater extent under conditions of free competition, it is a very pertinent point.

other with no increase in the total volume sold and manufactured. But effective selling efforts which build a large demand for the product may reduce manufacturing costs and thus prices. Moreover, advertising and personal salesmanship do give product information to consumers.[8]

It has been contended by some critics that, as far as the consumer's immediate interest is concerned, socially legitimate sales efforts should be confined to the announcement of new products or new uses for old products. According to this view, the purpose to be served by a product should be explained, the way in which it serves this purpose should be pointed out, and improvements in existing products and special prices could also be announced. But it may be questioned whether the consumer's long-run interests would be served if selling efforts were so confined. People are influenced to buy particular products anyway, and surely the hearsay remarks of other consumers, or the limited experience of the individual, are not the best ways in which to bring about the highest degree of consumer satisfaction. The informed salesmen or the advertising of the average vendor, who must usually look for future sales to the satisfaction his products give to purchasers, are in general much more reliable.

The selling process is, nevertheless, expensive. For not only are the facts concerning goods announced to us, but they are announced over and over again in every conceivable way. The consumer is not left alone to judge for himself, but every effort is made to influence his judgment. Mere announcement does not satisfy competitive needs. Many products offered for sale do not differ in any important respect from competing products serving the same purposes. But if products were merely announced, as has been suggested, individual vendors might not obtain so large a share of prospective volume as they hope to realize by using sales efforts that make the consumers think their products are really very different from, and superior to, all competing items. Consequently, some "selling point" or points must be found to differentiate their products from directly competing products—to individualize them. Then, by focusing the sales effort on a particular brand and its "different" characteristics, the seller tries to make prospective customers think they will make a great mistake if they do not buy it in preference to others. Now this may be true, but in many cases it will be found that these "selling points" are not basically important characteristics of the products sold, important as they may appear to individual consumers.

Granting all of this, however, it must be recognized that the competitive initiative of businessmen in creating demand for their own particular products has been a basic element in the development of modern industry. Moreover,

[8] For further elaboration of these points, see the discussion in Chap. 18.

the seeking of "selling points" with which to differentiate products has resulted in many important improvements in existing products and the development of new ones. In fact, it is safe to say that the wide variety of desirable products we enjoy today is a direct result of the efforts of businessmen to develop products which could be sold successfully. There is undoubtedly a certain amount of waste and inefficiency in competitive selling, but the benefits obtained from competition are significant. To the extent that there is waste and inefficiency, it may be regarded as one of the costs of economic freedom.

Inadequate Consumer Knowledge

Since the purpose of the enterprise system is to provide for the needs and wants of consumers, the efficiency with which the system functions depends to a considerable extent upon the actions of consumers. If consumers unknowingly or irrationally purchase inferior products at high prices in preference to superior products at low prices, they encourage the survival of the less efficient firms and discourage the efforts of the more efficient. Consumers provide the guiding force to an enterprise economy, and from the standpoint of efficiency it is important that they have sufficient knowledge upon which to base buying decisions that will result in maximum satisfaction.

The buying problem of the consumer has been discussed in previous chapters. It has been pointed out that many consumers apparently do not exercise great care in making buying decisions. It also has been pointed out that consumers often lack information about the particular characteristics and qualities of the products they purchase. By most objective standards, it can be concluded that consumers do not have adequate information. On the other hand, it is impossible to determine the exact effect of this lack of information upon either consumer satisfaction or the efficiency of the enterprise system. The ultimate consumer buys such a great variety of products, in comparison with the industrial buyer, for example, who is assumed always to be well informed and rational in action, that it is entirely possible that he has about as much information as he desires or as he can conveniently assimilate.

More than twenty years ago, the Committee on Distribution of the Twentieth Century Fund made a number of recommendations designed to increase consumer knowledge. These included more informative labeling, more widespread dissemination of buying information by government agencies, strengthening of the laws with respect to fraud and misrepresentation, more consumer education in the schools, and greater use of governmental

facilities for testing and appraising consumer goods.[9] Some progress has been made in most of these respects and particularly in the passage of laws requiring the labeling of textile products.[10] But, as the Committee stated at that time:

> . . . the problem of assisting consumers is not as simple as might at first appear. . . . the great majority of them have not shown any great interest in becoming better informed. And there is always the danger of imposing uncertain and incompetent judgments upon them. Our recommendations in the field of better consumer information, therefore, are made with the uncomfortable realization that, so far, consumers have not made very effective use of the facilities already available.[11]

The consumer should be given freedom of choice which includes the freedom to make mistakes. He should be given as much information as he desires and as he is willing to assimilate. Until such time as the consumer becomes more interested in the informational problem, complete buying information is not likely to be provided. The result presumably is that there has been, and will continue to be, inefficiency in marketing and in the enterprise system. But the extent of this inefficiency and its effect upon marketing costs cannot be determined. Very possibly, the effect is not so great as some critics of the marketing system would have us believe.

PRIVATE BUSINESS EFFICIENCY

The preceding discussion of the social efficiency of marketing obviously has not led to very definite conclusions nor to particularly specific suggestions for improvement, There is little doubt that inefficiencies exist, but it does not necessarily follow that drastic remedial action should be taken. As an example, efforts to restrict the number of middlemen or to eliminate some of the duplicative costs of competition would probably require legislative action that would restrict the freedom of entry into business. Such legislation does not appear to be in the public interest and might well lead to greater inefficiency in the competitive system than now exists. The legislation necessary to correct obvious abuses should, of course, be encouraged, but it is often a long and slow process to obtain even this. Therefore, it appears that the greatest likelihood of reducing marketing costs lies in the individual efforts of businessmen to improve their own efficiency in marketing. What can be accomplished through this approach?

[9] *Does Distribution Cost Too Much?* (New York: Twentieth Century Fund, 1939), pp. 349–54.

[10] See Chap. 25, pp. 536–7.

[11] *Does Distribution Cost Too Much?, op. cit.*, p. 349.

Much more attention has been paid historically to the problems of production management than to the problems of marketing management. Manufacturing has been studied from the so-called scientific management point of view since the latter part of the nineteenth century. Cost accounting for the manufacturing operation has long been used, and great emphasis is placed on the improvement of labor productivity in manufacturing. Most of the research budget of the average manufacturing firm is spent on the production phase of the operation. The study of marketing, on the other hand, has been much more slow to develop. Its importance in the total business picture was not realized much before the 1920s, and even then the average chief executive of a manufacturing firm was essentially production oriented. In recent years, there has been a definite shift in emphasis and more and more business firms are becoming marketing oriented. There is little doubt that marketing operations are being studied, and will be studied, very intensively in an effort to improve efficiency. The following discussion is suggestive of some of the lines of approach.

Better Distribution Cost Accounting

Intelligent management decisions require comprehensive information with respect to the costs of various alternatives. It is the function of cost accounting to determine the costs of specific activities and the costs and profits of particular segments of a business. Distribution cost analysis is concerned, of course, with costs that apply to the marketing operations, in particular with the determination of the cost of the various marketing activities and functions and the analysis of costs and profits by product lines, by customers, and by units of sale.[12] Distribution cost analysis is not so well developed as is factory cost analysis, partially because the practical problems are more complex, but considerable progress has been made.[13] Moreover, the development of electronic computers to perform the numerous and complex calculations that are often required has added greatly to the cost information available to marketing management.

The uses of distribution cost analysis in improving the marketing efficiency of the individual firm are many and varied. In the first place, there are the obvious uses with respect to expense control, budgetary planning, and pricing

[12] Committee on Distribution Costs and Efficiency, American Marketing Association, "The Values and Uses of Distribution Cost Analysis," *Journal of Marketing*, April 1957, pp. 395–6.

[13] Textbooks on the accounting aspects include J. B. Heckert and Robert B. Miner, *Distribution Costs*, 2nd ed. (New York: Ronald, 1953); and Donald R. Longman and Michael Schiff, *Practical Distribution Cost Analysis* (Homewood, Ill.: Irwin, 1955).

policy. But modern cost analysis attempts to answer more sophisticated types of questions. Taking into account all costs, how much finished goods inventory should be carried for each product line and item, and where should this inventory be located and in what amounts? How much does it cost to handle and fill orders of various sizes? Which customers and products are the more profitable? What are the costs of selling in the various sales territories and why do they differ? What cost differences are involved in various types of warehouse operations and what are the causes for these differences? The answers to these and other similar questions require the collection, allocation, and interpretation of detailed cost information. As a result of such analyses, many firms are controlling inventories more carefully, eliminating unprofitable product lines, changing the location of warehouse facilities, revising sales territories and the routing of salesmen, establishing new order handling procedures, and adopting a policy of selective selling. It is not necessary to discuss all of these developments in detail—many have been touched upon at other places in this book—but a few examples will illustrate the reduction in cost and the improvement in efficiency that can be made.[14]

Many manufacturers and wholesalers who have analyzed order costs and sizes have found that 50 per cent or more of all orders are handled at a loss. It is apparent that certain costs are relatively constant per item sold regardless of the number of each item ordered. It is also evident that other costs, such as delivery and the expense of a salesman's call vary but slightly with the amount of an order. And the actual cost of filling an order is likely to be as great for the small order as for the large, or even greater if original packages must be broken. It may not be feasible for sellers to eliminate all small orders, although some have done so, but at least it is not necessary to continue to encourage them through regular salesmen's calls and other expensive methods of solicitation. Firms which have been successful in reducing substantially the number of small orders through a policy of selective selling have reduced costs and increased profits, often very substantially.

This principle can also be extended to customers and sometimes to an entire class of customer. It is not uncommon for a manufacturer to find, after cost and profit analysis, that from one third to one half of his customers are unprofitable.[15] They are either so small or do so little business with him that an actual loss results on their purchases. Dropping these unprofitable customers and confining sales effort to the profitable ones tends to result in increased sales volume, reduced marketing expenses, and higher net profits.

[14] For a comprehensive discussion, complete with case illustrations, see Charles H. Sevin, *How Manufacturers Reduce Their Distribution Costs*, Economic Series No. 72 (Washington, D.C.: U.S. Department of Commerce, 1948).

[15] They account, however, for only a very small proportion of his total sales volume.

Further examples could be given with respect to product lines, package sizes, and various types of selling effort. There is a great difference in cost and profitability among orders, customers, products, and salesmen. It is one function of distribution cost analysis to discover and point out these differences. It is then the responsibility of management to take whatever action is appropriate to the particular situation. There is little doubt that substantial increases in marketing efficiency have been made through this approach. Even greater progress will be made in the future as more attention is paid to the analysis of distribution costs.

Increasing the Efficiency of Labor

Since labor cost represents such a high proportion of total marketing costs, the most logical approach to reducing marketing costs is to increase the efficiency and productivity of labor. Although this may be somewhat more difficult to accomplish in marketing than in manufacturing operations, there are several possible approaches. The efficiency of certain types of operations can be increased through greater mechanization and better work methods. Studies by the United States Department of Agriculture of supermarket operations have pointed out numerous possibilities of this type.[16] The use of conveyors to move merchandise from delivery truck to store room, the introduction of foot pedals to open doors and of foot-operated switches for power equipment used in meat-cutting operations, and the development of new materials handling equipment and of more efficient check-out counters are examples of increased mechanization leading to greater labor productivity. Improvement in the efficiency of wholesale warehouse operations has also been achieved through rearrangement ot stocks and other changes in work methods.

The most challenging opportunity, however, to increase labor efficiency in marketing lies in the improvement of the personnel function itself. The Department of Agriculture studies have pointed out that there is even less research being done in the field of employee skill and motivation than on the subjects of mechanization and operating procedures.[17] Richard D. Crisp states that many sales organizations have an operational effectiveness, in comparison with what could easily be achieved, of from 50 to 60 per cent.[18] Studies of the

[16] See Martin Kriesberg and R. W. Hoecker, "Productivity of Food Marketing Personnel," *Journal of Marketing,* April 1954, esp. pp. 387–9.

[17] *Ibid.*, p. 389.

[18] Richard D. Crisp, "The Challenging Opportunity to Boost Profits by Reducing Distribution Costs," in Lynn H. Stockman (ed.), *Advancing Marketing Efficiency* (Chicago: American Marketing Association, 1959), p. 401.

utilization of salesmen's time indicate that field salesmen average only about 30 to 35 per cent of their total time in actual selling. This might not represent too great inefficiency, since waiting time and travel time are necessarily substantial factors, but it is further contended by many persons that much of the actual selling time is spent with the wrong customers.[19]

There is little doubt that much remains to be done in the field of personnel selection, training, and supervision. The starting point is to establish specifically for each position what the job is and what the requirements are for filling it. Then it is necessary to match more precisely the abilities and interests of job applicants to job requirements. Carefully designed aptitude tests, which are being used more and more in the selection of marketing personnel, are useful in this connection, along with the other more common selection devices. The next step is to see that those selected are properly and thoroughly trained to do the job for which they have been selected. There is considerable evidence that a lack of training, as well as the use of ineffective training methods, is responsible in a substantial degree for the poor performance and the lack of motivation displayed by many marketing employees.[20]

Finally, adequate supervision and control of personnel must be maintained. The establishment of performance standards is often helpful in raising the level of achievement. Sales quotas for territories and for individual salesmen, the "normal" time required for a truck and driver to cover a specific delivery route, and the number of tons of merchandise to be handled per man-hour worked in the warehouse are examples of performance standards which give employees an idea of what is expected of them. Salesmen and delivery personnel should not be left to their own devices in planning the routes that they will follow, since the utilization of central supervision and planning usually results in less backtracking and a saving of time. Distribution cost analysis can also be utilized, along with personal supervision, to direct the efforts of salesmen to the more productive customers and the more profitable products. For those cases in which the salesmen's task is somewhat repetitive, time and duty analysis can be used to reveal weaknesses in the salesmen's performance. Time and duty analysis, an adaptation of industrial motion and time study, studies specifically how the salesman divides his time among

[19] Essentially this is an argument for selective selling, as discussed in the previous section. See Douglas P. Gould, "Marketing's Improving Efficiency in the 1960's," in Wenzil K. Dolva (ed.), *Marketing Keys to Profits in the 1960's* (Chicago: American Marketing Association, 1960), p. 125.

[20] For results of an interesting experiment on training methods, see Martin Kriesberg and R. W. Hoecker, *op.cit.*, p. 390.

his various duties and the effectiveness of his selling methods. It can be very helpful in pointing out possibilities for improvement.

The problems of personnel selection, training, supervision, and control are likely to be more complex in marketing than in manufacturing. Much of the work, especially that involved in selling, requires an individual with creative ability and imagination. The nature of the work is such that he is often located or working at some distance from a supervisory official. It is difficult, therefore, to adapt to marketing many of the personnel techniques that have been successful in manufacturing. Moreover, many marketing firms, especially retailers, are very small and cannot afford to devote the necessary time and effort to personnel matters. Therefore, marketing personnel apparently have not achieved the degree of efficiency that has been obtained by manufacturing personnel. It is to be expected that more and more management attention will be devoted to this problem in the future, and it is to be hoped that significant improvements will be effected.

The Role of Marketing Research

In order to achieve greater efficiency in marketing, it is necessary to spend more effort and money on marketing research. It is basically through research that many of the problems of distribution cost analysis and of labor efficiency will be solved. In addition, research is necessary to determine the products and services desired by consumers and the best methods of supplying them. Despite the constantly increasing sums of money being spent on marketing research, especially by the large manufacturers, most firms are still placing the greater emphasis on production research. Relatively few concerns have recognized fully the potential benefits to be derived from marketing research. Moreover, very few of the firms that do place an emphasis on marketing research are actually working on improvements in marketing methods.[21]

There appear to be several reasons for this lack of emphasis upon marketing research. Marketing problems are more complex and less tangible than production problems, and their solution appears perhaps to be a matter of less immediate urgency. Standards for measuring marketing efficiency have not been so well established nor so widely accepted as have standards of production efficiency. Thus it has been difficult for executives to see and appreciate the potential benefits of marketing research. In addition, it is be-

[21] See Theodore Levitt, "Growth and Profits Through Planned Marketing Innovation," *Journal of Marketing*, April 1960, pp. 1–8.

lieved by many marketing research practitioners that the administrative responsibility for distribution research is too widely scattered in the average business organization to permit effective discharge of the function. This, of course, may well reflect the lack of executive acceptance of the importance of this type of research.[22]

Some of the uses of marketing research have been discussed previously in Chapter 24, but the emphasis there was on obtaining information about the market. Important as this is, effective marketing research can do much more to improve distribution efficiency. One of the areas of marketing research which has received substantial emphasis is that of advertising research. Copy testing and media research have done much to improve the efficiency of specific advertisements and even of entire advertising campaigns. And yet few companies have any real knowledge of whether they are spending the right amount, or too much, or too little, for advertising. The same situation exists in many other aspects of marketing. Research has been done perhaps on specific aspects of a marketing problem, but there may be little basic knowledge regarding the efficiency of the over-all operation.

Information is needed about many phases of marketing: costs and profits by products and by customers, sales potentials by territories and by products, warehousing and delivery requirements for maximum customer service and minimum cost, the necessary amount of finished goods inventory considering customer service and cost, the most economical order handling and billing procedures, the best materials handling methods, the most efficient warehouse layout for a given purpose, effective methods of stimulating salesmen and other marketing employees, and many others. The possibilities for increasing marketing efficiency through more and better research are very great. But it will not be easy to obtain answers to all of the problems of marketing.

Without doubt, there will be an increasing emphasis in the future on marketing research, a natural result of the constantly increasing emphasis on marketing in our economy. Many business firms are reorganizing their marketing operations to achieve unified authority and responsibility. A new concept of marketing is being formulated by these firms, a concept which places marketing at the center of the business universe and which requires that all executives be marketing oriented regardless of their specific functions in production or finance. With this shift in emphasis from production to marketing, the result can only be further study of marketing in an effort to reduce costs and improve efficiency.

[22] For a further discussion of the points made in this paragraph, see Charles W. Smith, "Increasing Distribution Efficiency by Better Organized Research," *Journal of Marketing*, January 1953, pp. 235–6.

CONCLUSIONS

Any consideration of marketing efficiency must start with certain facts clearly in mind. So long as we have large-scale production and specialized producing units and production areas, so long as production takes place in anticipation of demand, so long as the consumer desires expensive services and products from distant places, just so long must we have a large and intricate market organization. And the larger and more specialized producers become, the more numerous the desires and wants of consumers are, and the more numerous the products become that are required to satisfy consumer wants, the more important the market machinery will be. It must be recognized that the benefits of specialization in production are offset in part by the increased costs of marketing. Perhaps a point might be reached eventually in some industries at which the increased costs of marketing would offset the advantages of large-scale production, but there is little evidence thus far that this is occurring.

Nevertheless, it is important to continue with, and to develop further, the work of the various agencies, public and private, which is directed toward improving the methods of marketing. So expensive a part of our industrial mechanism as the marketing machinery requires careful study. But it is an intricate and delicate mechanism, and change should develop only from investigation and experience. The individual interests of private businessmen may be expected to do much to improve the technique of individual types of operation. It is these efforts which will prove most valuable, since under an economic system dependent primarily on individual initiative we must look to such initiative as the primary source of improvement. Nevertheless, governmental action will continue to be an essential element in the development of a proper functioning between competing firms and between different economic societies, as well as in the protection of the public from the antisocial results of extreme competition and of monopoly.

QUESTIONS FOR DISCUSSION

1. The Twentieth Century Fund in its 1939 study *Does Distribution Cost Too Much?* concluded that distribution does cost too much but it could not state how much too much. Moreover, it stated that no conclusion could be drawn that "distribution is more or less wasteful than production." Reavis Cox has stated that considering what the distribution system does for us "the marvel is not that it costs so much but that it costs so little." Can these statements be reconciled? What are your conclusions regarding the cost and efficiency of marketing?

2. A wholesaler computes his order handling cost at 50 cents per order plus 25 cents for each line on the order. He also has delivery costs and the costs of salesmen's calls. Based on the average gross margin of the products sold, he decides that he is losing money on single-line orders of less than $10.00, on two-line orders of less than $11.00, on three-line orders of less than $12.00, and so forth. What are the various types of action that he might take to remedy the situation of too many small orders?
3. As of 1948 about 2½ per cent of the total labor force of the U.S.S.R. was employed in domestic trade compared with 12 per cent in the United States (see the Henry H. Ware reference cited below). How do you account for this difference? Does this mean that the marketing system of the U.S.S.R. is more efficient than that of the United States?

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See also references at end of Chapter 31.

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